

Installment Method of Reporting Income Its Election Use and Effect

Meade Emory

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THE INSTALLMENT METHOD OF REPORTING INCOME: ITS ELECTION, USE, AND EFFECT

Meade Emory†

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† Associate Professor of Law, The University of Iowa. A.B., 1955, LL.B., 1958, George Washington University; LL.M., 1963, Boston University. The author wishes to acknowledge the invaluable contribution of his Research Assistant, Robert Burns Mossman, a senior at the College of Law, University of Iowa.

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I

INTRODUCTION

Traditionally, teachers of taxation have classed problems concerning "when is it income?" as of no less importance than those relating to "is it income?" The "when" of income is significant because of various factors, *e.g.*, tax rate changes, rate progressivity, statutes of limitation, and alteration in the substantive law. As sound as this lesson may be, tax accounting problems have long been neglected in the periodicals and shunted aside by lawyers, presumably to be left to their brethren in accountancy, who are, after all, certified to comprehend the special mystique of clearly reflecting income. Recently, however, lawyers have increasingly tackled these unfamiliar problems. The 1964 spin-off of a new Committee on Tax Accounting Problems from the General Income Tax Committee of the Section of Taxation of the American Bar Association probably reflects more than a mere realignment of the Section's committee structure.¹ The dilemmas surrounding deferred compensation arrangements, prepaid income, and reserves for estimated expenses (which recently have generated a spate of high-level judicial pronouncements) and the wide scope of problems caused by the existence of an annual accounting period² have been sufficiently important to attract the attention of most tax practitioners. But conceptions involved in analyzing and resolving these problems are not generally handled with facility by lawyers, even though the disputes arise and are dealt with in a familiar context.

Although the statutory provisions relevant to these questions are generally terse,³ in one area Congress has specifically provided ma-

¹ ABA TAXATION SECTION ANN. REP. 34-35 (1964).

² *E.g.*, the inclusion of disputed and unliquidated items, and the amorphous scope of the tax benefit doctrine.

³ "The general answer to most of these *when* questions is furnished by sections

chinery that can control the time of income from certain types of sales transactions. The reporting of income from qualifying installment sales, controlled as it is by statute,⁴ should not be alien terrain for the lawyer. Legislative and administrative pronouncements are tools with which he can work with facility. The rise in comprehension level is due in part, no doubt, to the fact that the installment method of reporting is not an accounting method at all.⁵ If the period over which payment is to be made is relatively short and there exists little possibility of nonperformance by the buyer (or loss, in the case of repossession), the method cannot be considered in conformance with general accounting principles. If employed for financial statement purposes, it would likely cause distortion.⁶ That the method is relevant only to taxation enables the tax practitioner to approach problems arising thereunder with a minimum of awe.

Like much of tax law, the installment method of reporting income owes its existence to the legislative penchant for encrusting the statute with all manner of filigree designed to alleviate specific hardships. Because of its versatility, the installment method is not particularly controversial. The proper categorization of the installment method in tax syntax is, however, a necessary prelude to the discussion of its use and effect. Essentially it is an income deferral technique and does not affect established concepts of income realization and recognition.⁷ As

441(c), 446, 451(a) and 461(a) in terms of the method of accounting regularly employed by the taxpayer in his business or record keeping." S. SURREY & W. WARREN, *FEDERAL INCOME TAXATION* 430 (1962) (emphasis in original).

⁴ INT. REV. CODE OF 1954, § 453.

⁵ It is not a "method" for purposes of INT. REV. CODE OF 1954, § 446(e), which requires consent for changes in accounting method. Treas. Reg. § 1.453-8 (1958), *as amended*, T.D. 6682, 1963-2 CUM. BULL. 206.

⁶ J. ACCOUNTANCY, July, 1958, at 79.

⁷ Cf. Wallace Huntington, 15 B.T.A. 851, 858-59 (1929). The early regulations were framed in a manner that denied, with regard to qualifying sales, that the buyer's obligations had the equivalence of cash. Treas. Reg. 45, § 213, art. 45 (1921). It is far better to view the statute as not affecting general principles of realization but as simply constituting an optional method for income deferral. *In re Rogers' Estate*, 143 F.2d 695 (2d Cir. 1944). See also Rev. Rul. 65-99, 1965-1 CUM. BULL. 242; Ivan Irwin, Jr., 45 T.C. 544, 550 (1966). In Rev. Rul. 60-68, 1960-1 CUM. BULL. 151, the Commissioner authorized the use of § 453 in reporting gain from the sale of the stock of a collapsible corporation, but concluded that receipt of an installment after the end of the 3-year period during which § 341 is applicable would not affect the ordinary income treatment provided by that section. Note that a corporation, reporting income under § 453, "shall," with respect to such transactions, use that method in the computation of its earnings and profits. Treas. Reg. § 1.312-6(a) (1955). In *Municipal Bond Corp.*, 41 T.C. 20, 32 (1963), *rev'd on other grounds*, 341 F.2d 683, 691 (8th Cir. 1965), the Commissioner was held not to be estopped from treating as ordinary income payments received on sales made in closed years, because he was simply determining "petitioner's tax liability on income received

such it possesses a marked kinship with other authorizations for the deferral or spreading of income. The complex network in authorization of a spread-back of income which is found in the income averaging provisions of the code is analogous, but different in important respects.⁸ Income averaging mitigates the hardship imposed by the progressive rate structure upon greatly uneven income levels of different years, whereas the installment method recognizes that adversity would often result if the taxpayer were compelled to account for income not yet received. Both situations, however, represent a violation of general tax accounting concepts and of the segmentation of income into fixed one-year time periods.⁹

As with any body of principles that are inconsistent with the concepts normally applied, it is essential to know with reasonable certainty which situations are within its scope. Thus, much of the discussion of the installment method must be aimed at establishing the perimeter of the statutory authorization. Then, of course, attention must be directed to the effect of the method once it is properly chosen.

II

DEVELOPMENT AND GROWTH OF THE STATUTORY AUTHORIZATION

A. *The Need for the Enactment and a Comparison with Other Principles*

Ever since the Revenue Act of 1916, federal tax laws have provided that income can be returned in accordance with the method of accounting used by the taxpayer, as long as the method clearly reflects income.¹⁰ This authorization manifestly incorporates the cash and accrual methods. It has long been understood that, for gain determi-

during the taxable years now under consideration." Treas. Reg. § 1.1231-1(d)(3) (1957) makes it clear that installment payments received during the year are to be considered in netting § 1231 transactions for that year even though the sale generating the payment occurred in a prior year.

⁸ INT. REV. CODE of 1954, §§ 1301-05.

⁹ Postponement of present income is also available through the vehicle of qualified pension and profit sharing plans. INT. REV. CODE of 1954, §§ 401-04. Administrative inroads on general concepts are also found both in the regulation permitting the use of the percentage-of-completion method in long-term construction contracts, which allows a spread-out of income that might otherwise be bunched if traditional concepts were employed, Treas. Reg. § 1.451-3 (1957), and in the Commissioner's authorization of deferred compensation arrangements outside the explicit statutory framework. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.

¹⁰ Revenue Act of 1916, ch. 463, §§ 8(g), 13(d), 39 Stat. 756 (now INT. REV. CODE of 1954, § 446).

nation purposes, property received in a form other than cash, but having a cash equivalent, will be treated as an amount realized by a cash basis taxpayer in the year of receipt.¹¹ Thus, a promissory note is property and may be assigned a present value even though the terms of the obligation specifically provide that the payments are to be deferred and made on specific future dates well after the close of the year in which the sale transaction occurred.¹² No doubt this principle goes some way toward the obliteration of the fundamental distinctions between the cash receipts and accrual methods.¹³

This long-established principle of realization stands completely apart from the doctrine of constructive receipt. If the property (whether cash or its equivalent) forming a part of the sale price is placed beyond the seller's dominion, then it is not regarded as realized by the seller for gain or loss realization purposes. Usually, property that takes the form of an obligation to make deferred payments is clearly within the taxpayer's dominion even though the payments themselves are deferred.¹⁴ Another distinct problem arises when the value of the property received by the selling taxpayer cannot be determined. Because of

¹¹ The statute itself seems to compel this result. INT. REV. CODE OF 1954, § 1001(b).

¹² The obligation may have a value less than face, in which event the amounts in excess of such value shall be treated as income when received. Treas. Reg. § 1.453-6 (1958). See generally Note, *Taxation of Deferred Payment Sales of Realty and Casual Sales of Personality*, 1966 UTAH L. REV. 195. Some evidence of indebtedness (e.g., notes, bonds, etc.) other than a mere contractual promise to pay may be prerequisite to a finding that a "cash equivalent" has been received by the taxpayer. 2 J. MERTENS, *FEDERAL INCOME TAXATION* § 11.05 (1961). Situations in which the buyer's promise does not constitute a cash equivalent offer deferral to a cash basis taxpayer, because the seller is allowed to recover his cost prior to returning income. Estate of Coid Hurlburt, 25 T.C. 1286 (1956), not acquiesced in, 1956-2 CUM. BULL. 10; Nina J. Ennis, 17 T.C. 465 (1951). Such deferral is not available to accrual basis taxpayers, who are treated as realizing the face value of the buyer's obligation. First Sav. & Loan Ass'n, 40 T.C. 474, 487 (1963); George L. Castner Co., 30 T.C. 1061 (1958); cf. C.W. Titus, Inc., 33 B.T.A. 928 (1936). The installment method, however, is equally available to cash and accrual basis taxpayers. Rhombar Co., 47 T.C. 75 (1966). The fact that the buyer's promise to pay does not rise to the dignity of a cash equivalent should not alter the selling taxpayer's right to compute and return the income from a property disposition under § 453. Thus, "evidences of indebtedness," as used in § 453(b)(2)(A)(ii), cannot be taken as necessarily referring to an obligation having a cash equivalent.

¹³ Since different principles are at work, however, the accrual method, premised upon the unconditional right of payment, may often result in a greater amount realized than the cash receipts method, which treats the obligation of the buyer (discounted for valuation) as the equivalent of cash. S. SURREY & W. WARREN, *supra* note 3, at 653. Merchants generally accrue obligations at face value, using a bad debt reserve or a specific deduction as individual accounts prove uncollectible.

¹⁴ Some of the confusion that has existed between the doctrines of cash equivalence and constructive receipt is chronicled in Comment, *Receipt of Deferred Payment Contracts as Income to the Cash Basis Taxpayer*, 58 NW. U.L. REV. 278 (1964).

the valuation problem, selling taxpayers may recover the basis of disposed property prior to reporting gain. The area is probably just as indefinable as it was after the Supreme Court spoke in *Burnet v. Logan*.¹⁵ All consideration of so-called "open" transactions is ominously pervaded by the Commissioner's position that "only in rare and extraordinary cases will property be considered to have no fair market value."¹⁶ Property that takes the form of an obligation to pay a specific amount in deferred payments is almost always readily susceptible to valuation. Thus, absent administrative concession or legislative authorization, cash basis taxpayers selling property in transactions that call for deferred payment would be subject to taxation in the year of sale, pursuant to relatively ancient principles of realization.

The considerations that compelled administrative, and subsequently legislative, recognition of the installment method are fairly clear. When a seller receives only a small part of the selling price at the time of sale, it is not always fair to hold him responsible for the contemporaneous payment of the full tax liability generated by the sale. Use of the installment method of reporting income usually has the coincidental advantage of making it unnecessary to value the buyer's obligation at the time of sale.¹⁷

B. *Form of the Enactment*

Prior to their enactment as part of the Revenue Act of 1926, the statutory provisions governing the installment method of reporting contained a rather ambiguous reference to installment dispositions, stating simply that the statute should not be construed to prevent

¹⁵ 283 U.S. 404 (1931). The taxpayer sold shares of stock in a mining company in return for a present payment of cash and a promise of future payments contingent upon the amount of ore produced each year. The Court held that, until the receipts by the taxpayer equalled the basis of her shares, the payments were return of capital and not taxable as income. The transaction was not closed, since the taxpayer might never recover her capital investment from payments received under the conditional promise, which was in no proper sense the equivalent of cash.

¹⁶ Treas. Reg. § 1.1001-1(a) (1957). Articulating an identical warning are Treas. Reg. § 1.453-6(a)(2) (1958) and Rev. Rul. 58-402, 1958-2 CUM. BULL. 15.

¹⁷ Obviously, the opportunity for deferral in a *Burnet v. Logan* situation (no income realization until the recovery of basis) is greater than under § 453, where a portion of each installment is treated as income. Analogously, if the obligation of the buyer has no fair market value, a sale treated as a deferred payment sale not on the installment plan will allow the seller fully to recover his basis prior to reporting gain, and may thus be superior to the installment method, which provides for a pro rata return of capital and of income. Treas. Reg. § 1.453-6(a)(2) (1958).

A seller's effort to render a potentially "open" transaction eligible under § 453 will, of course, involve some effort to value what the seller is to receive in order to determine the "total contract price."

"taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received."¹⁸ The statement took on meaning only when placed against the background of a prior administrative authorization to use the installment method of reporting income.¹⁹ This vagueness set a surprising stage for the judicial action that ensued.

The administrative approval of installment reporting was shaken by early decisions of the Board of Tax Appeals which found that the method did not accurately reflect income.²⁰ The Board was disturbed by what it felt to be the distortive effect of the income drop-off that resulted when a taxpayer changed from the accrual to the installment method.²¹ The judicial abrogation of the Commissioner's grant induced the more explicit legislative statement contained in the Revenue Act of 1926.²² This permitted use of the installment method by persons who regularly dispose of personal property and also with regard to

¹⁸ Revenue Act of 1921, ch. 136, § 202(f), 42 Stat. 231. This same statutory language is now codified in INT. REV. CODE of 1954, § 1001(d), where it apparently serves to coordinate the general realization provisions with § 453. Its presence prior to the enactment of the statutory authorization of the installment method is curious.

¹⁹ The installment method first appeared in regulations issued in 1918 in a form that strongly resembles the present statute:

In the case of a contract to sell real property or other property on the installment plan, title remaining in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price.

Treas. Reg. 33, art. 117 (rev. 1918). Strangely, the administrative authorization seemed to call for mandatory rather than elective use of the method if the sale was within its scope. In 1919 expanded regulations deleted the requirement that title be retained by the vendor, and allowed use of the method as long as the seller employed one of a number of other techniques to preserve his interest, e.g., a mortgage executed by the vendee, or property subject to a lien for unpaid amounts.

²⁰ B.B. Todd, Inc., 1 B.T.A. 762 (1925). See also A.R. Dennis, 2 B.T.A. 977 (1925); The Hoover-Bond Co., 1 B.T.A. 929 (1925); H.B. Graves Co., 1 B.T.A. 859 (1925).

²¹ To report . . . upon a basis which considers only the profit upon the business entered into during a year which is actually reduced to possession in cash, and to exclude all business of prior years reduced to possession in cash, at the same time deducting as expenses all accrued obligations, is to destroy all relationship between the true net income and the income reported for taxation.

B.B. Todd, Inc., 1 B.T.A. 762, 766 (1925).

²² Ch. 27, § 212(d), 44 Stat. 9, 23. The legislative authorization was made retroactive to years covered by prior revenue enactments. *Id.* § 1208, at 130. Some of the vagaries that marked the Commissioner's administration of the prior regulations with regard to what constituted a qualifying installment sale are described in *Hearings on Revenue Revision for 1925 Before the House Comm. on Ways and Means*, 69th Cong., 1st Sess. 880-82 (1925). Also persisting is the opening language ("under regulations prescribed by the Commissioner with the approval of the Secretary"), which serves to render the Commissioner's regulations almost impregnable. E.g., *Burnet v. S. & L. Bldg. Corp.*, 288 U.S. 406, 415 (1933).

casual sales of personalty for more than \$1,000 and sales of real property "if in either case the initial payments do not exceed one-fourth of the purchase price." The three-part form of the statute has persisted to this day. The accompanying committee reports clearly indicate that a failure to come within the provision would result in taxation of the gain to the selling taxpayer in the year of sale, with obligations owed to cash basis taxpayers being assigned a cash equivalence in determining the amount realized.²³

In 1928 the essential form of the installment sale authorization was retained except for an increase, from twenty-five percent to forty percent of the selling price, in the ceiling on year-of-sale receipts in sales of realty and casual sales of personalty.²⁴ The ceiling on the amount that can be received by the seller in the year of sale helps to insure that the disposition is one in which the imposition of a full tax in the year of sale would cause hardship.²⁵ As will be seen later, this threshold

²³ S. REP. NO. 52, 69th Cong., 1st Sess. 19 (1926). By indicating that "deferred-payment contracts other than installment contracts" were not affected by the statute, the Committee adopted a confusing nomenclature. Presumably any property disposition in which the seller does not receive the entire payment in cash (or other property in a form other than evidences of indebtedness) in the year of sale, but receives the buyer's promise to pay some or all of the consideration at a later date, constitutes a deferred payment sale. The installment method authorized by § 453 represents one manner in which such sales can be reported. The deferred payment method, handled administratively with regard to sales of realty (Treas. Reg. § 1.453-6 (1958)) and judicially with regard to sales of personalty, and the return of capital method pronounced in *Burnet v. Logan*, constitute the other available techniques. The deferred payment method, insofar as it authorizes the valuation of the purchaser's obligations at less than face and the computation of gain on that basis, seems available only to cash basis and not to accrual taxpayers, the latter being compelled to treat the obligation as having accrued at face. After the cash or cash equivalent has been reported by a cash basis taxpayer pursuant to this method, deferral of the amount by which the face value of the obligation exceeds its fair market value is available. Note, *supra* note 12, at 198.

²⁴ Revenue Act of 1928, ch. 852, § 44(b), 45 Stat. 791, 805.

²⁵ The regulations preceding statutory authorization bestowed potential installment method treatment on transactions where "the initial payment is relatively small." Treas. Reg. 45, arts. 44, 45 (rev. 1919). If the payment in the year of sale is "large," the seller is better able to pay a tax contemporaneous with the sale, and the likelihood of full performance by the buyer is greater. Thus, principles of cash equivalence may properly control. There has been some difficulty, however, in properly drawing the line. During hearings on revenue revision in 1928, representatives of the real estate industry (largely developers) made a plea that a ceiling on year-of-sale payments in dispositions of realty by dealers be removed entirely and that such transactions be grouped with those made by dealers in personalty. They asserted that, in order to insure qualification, property would have to be sold for an initial payment of 10% down lest monthly payments in the year of sale would result in disqualification. Since sales on this basis were unsound for business reasons, it was urged that real estate dealers were treated unfairly vis-à-vis dealers in personalty. *Hearings on Revenue Revision for 1927-1928 Before the House Comm. on Ways and Means*, 70th Cong., 1st Sess., 162-63, 224-30, 246-50 (1927). Although these pleas

qualification has produced a sizeable portion of the litigation arising under the statute.

The Revenue Act of 1928, however, added a curious form of double taxation in order to prevent a drop-off to a "seriously subnormal amount of income"²⁶ in transition years following the taxpayer's (limited to dealers in personal property) decision to change from the accrual to the installment method. The provision required the changing taxpayer, in years subsequent to the decision to change, to report amounts received on account of sales made prior to the change and previously reported pursuant to the accrual method. Thus, if a dealer in personalty had sold property with an aggregate basis of \$20,000 for a total selling price of \$100,000, according to the accrual method he would have reported a gain of \$80,000. If for the next tax accounting period he adopted the installment method, there would be a considerable drop-off in the level of his taxable income, even assuming a similar sales volume. Subsequent receipts on account of prior sales presumably would be received tax-free, the profit from them having been previously included in income pursuant to the accrual method, and amounts received for current sales would be reported pursuant to the newly-adopted installment method, allowing the taxpayer to spread the profit over the years during which the payments were received. This subnormality in income level would continue for a period of years, depending on for how long the taxpayer's business generally extended credit, until the profits of prior years includible in income pursuant to the installment method come in closer relationship with the profits being deferred by use of the method. The drop-off in income level, especially in periods of rising tax rates, was apparently too bitter a pill for a concerned Treasury and a responsive Congress. The response fashioned was a legislative abrogation of general accrual concepts, taking the form of a mandate that subsequent receipts on account of prior sales (the profit on which had already been included in income according to the taxpayer's prior accrual method) "shall not be excluded." This double-tax potion was only initially unappetizing to the Congress;²⁷ when informed of the reward awaiting the taxpayer who

were unsuccessful, the arguments presented may well have resulted in the increase of the ceiling to 40%. H.R. REP. NO. 2, 70th Cong., 1st Sess. 14 (1927). The Revenue Act of 1934, ch. 277, § 44, 48 Stat. 680, 694, decreased the ceiling to 30% (at which it has since remained) for the reason that a higher level caused "an unreasonable postponement of tax in cases where such tax can well be paid in the year of the sale." H.R. REP. NO. 704, 73d Cong., 2d Sess. 24 (1934).

²⁶ H.R. REP. NO. 2, 70th Cong., 1st Sess. 15 (1927).

²⁷ The "double tax" rule presents one of the strangest situations I have ever

exercised the "advantageous option"²⁸ of changing from the accrual to the installment method, the statutory remedy became palatable.

The host of problems touching the disposition of installment obligations, not dealt with in prior enactments, was taken up in the 1928 Act.²⁹ Presumably the sale of an installment obligation, even absent a statutory directive, would yield income to the seller equal to the excess of the amount realized over the basis of the installment obligation in the hands of the seller, the latter being determined according to fairly well recognized basis allocation concepts. There existed, however, situations in which the disposition of installment obligations would not necessarily produce gain to the transmitting party but would leave the obligation in the hands of the recipient at a higher or stepped-up basis, thus removing from the tax the income which had been deferred by reason of the decision to adopt the installment method on the original sale. For example, corporate disposition of an installment obligation, by way of a liquidating or nonliquidating distribution, would not be a recognizing event to the distributing corporation and would leave the obligation in the hands of the distributee at a fair market value basis. The transmission of an installment obligation by death would not be a realizing event to the decedent or his estate; it would result in assigning the obligation a fair market value basis in the hands of the beneficiary or other distributee, thus, again, removing the gain deferred by reason of the installment method election from the grasp of the income tax. Although the transfer of an installment obligation by gift would not have the same potential for revenue loss, since the donee would preserve the transferor's basis in the property given,

witnessed. Everyone upon hearing the matter discussed for the first time becomes almost enraged at the thought of taxing the same income twice. After a further study, however, the first reaction suffers a complete reversal.

69 CONG. REC. 7707 (1928) (remarks of Senator Smoot). The change now codified in § 453(c)(2) (allowing an adjustment of the tax as a result of the double inclusion) does not reflect such firm convictions. Almost all of those giving testimony were adamantly opposed to legislative acceptance of the Commissioner's double tax position. *E.g.*, *Hearings on Revenue Revision for 1927-1928 Before the House Comm. on Ways and Means*, 70th Cong., 1st Sess. 221-24, 283-99 (1927). The uncertainty of this position prior to the 1928 enactment is fully chronicled in *Willcuts v. Gradwohl*, 58 F.2d 587 (8th Cir. 1932), and *Hoover-Bond Co. v. Denman*, 59 F.2d 909 (6th Cir. 1932). The sole witness in support of the course eventually taken was hardly convincing:

When you let a man go into the installment business you are giving him something and you have a right to prescribe conditions. The complaint is that there is double taxation. Even if there is double taxation the installment people are getting away with the best of it, and you have a right to prescribe the conditions upon which a man should go on the installment basis if you want to.

Hearings on H.R. 1 Before the Senate Comm. on Finance, 70th Cong., 1st Sess. 52 (1928).

28 H.R. REP. No. 2, 70th Cong., 1st Sess. 15 (1927).

29 Revenue Act of 1928, ch. 852, § 44(d), 45 Stat. 791, 806.

the assignment itself would not constitute a realizing event to the donor, thus opening, it might be felt, a small opportunity for avoidance through the assignment of income. Operating upon the theory that the deferral of income through election of the installment method was a privilege personal to the taxpayer originally making the decision to so defer income, the Congress provided that a disposition of the obligation by him (by any one of a number of means) compelled the recognition of the deferred income at the time of transfer. Thus, a personalizing of the use of the method evolved through a desire to prevent abuses in which the transferee took the obligation at an increased basis and the transferor generally realized no gain. The rough hewn tool that Congress fashioned in 1928 has frequently been amended. These provisions, now contained in section 453(d), are complex and, since they concern a separable segment of the larger area under discussion, are more properly dealt with in a subsequent article.³⁰

Surprisingly, the statute authorizing the method's use has, except for some minor changes, persisted very close to its original form. The categorization of eligible sales wrought by the statute itself constitutes an appropriate format for its discussion.

III

SALES OF REALTY AND CASUAL SALES OF PERSONALTY

The statutory separation of sales of personalty by a dealer from casual sales of personalty and sales of real property appears to be rational. The varying treatment accorded dealers and nondealers in sales of personalty is no doubt necessitated by the manner in which dealers report income from property sales and by a desire to bestow the deferral benefit offered by the statute only upon relatively sizeable sales of personalty. Real property, whether sold by a dealer or not, was more properly paired with casual sales of personalty; because of the myriad forms such transactions can take, each sale properly constitutes a separate elective opportunity, calling for a separate computation of gain. Because of this categorization, many of the problems involving casual sales of personalty may be treated together with those involving sales of real property.

A. *Qualifying Sales—Generally*

1. *The Need To Have an "Installment Plan"*

Eligibility for income deferral appears to require classification of the transaction as a sale on the installment plan. Curiously, neither the

³⁰ The author is presently preparing an article dealing with the disposition of installment obligations.

statute nor the administrative material thereunder define an installment plan sale. Although precise definitional matter appears in the regulations dealing with sales of personal property by dealers,³¹ the form in which the statute is cast makes it logical to assume that the definition there employed may not properly apply to casual sales of personalty and sales of realty falling within section 453(b). Early decisions of the Board of Tax Appeals struggled for a workable notion of what constituted an installment sale.³² In one case, a dictionary definition of an installment as a partial payment on an amount due led the Board to conclude that transactions involving a single payment, though due in the future, could not qualify under the statute.³³ In *James McCutcheon & Co.*,³⁴ a 1928 contract for the sale of securities provided for payment "on or before October 21, 1932 with interest thereon" and stated that the dividends paid on the stock, being held by the seller, were to be applied toward the purchase price. The Board determined that the transaction was not an installment sale, because the contract made no reference to the dates upon which dividends were to be paid, or to the amount thereof. The "sole unconditional obligation" was to make full payment before October 1932.³⁵ In failing to consider that the dividends yielded by the stock during the year of sale constituted an initial payment, the Board apparently held that the existence of a specific and definite contractual obligation to make installment payments that are certain in amount is essential to the existence of an installment sale.³⁶

A closer reading of the statute soon yielded a softer administrative position. The statute simply provides that income from the casual sale of personalty (where the selling price exceeds \$1,000) and from the sale of realty may be returned in the same manner as that afforded electing dealers in personalty if the amount paid in the taxable year of sale does not exceed a specified percentage of the selling price.³⁷ Thus, the Commissioner determined that the "sole test" in determining qualification "is whether the initial payments . . . do not exceed [the specified percentage] of the selling price."³⁸ This conclusion, eschewing considera-

³¹ Treas. Reg. § 1.453-2(b), T.D. 6682, 1963-2 CUM. BULL. 198.

³² *James McCutcheon & Co.*, 30 B.T.A. 1177 (1934); *Walnut Realty Trust*, 23 B.T.A. 850 (1931); *Thomas F. Prendergast, Ex'r*, 22 B.T.A. 1259 (1931).

³³ *Thomas F. Prendergast, Ex'r*, 22 B.T.A. 1259 (1931).

³⁴ 30 B.T.A. 1177 (1934).

³⁵ *Id.* at 1182.

³⁶ The idea that a transaction is an installment sale only if the contract specifically provides for the making of installment payments also appears, albeit confusingly, in *Walnut Realty Trust*, 23 B.T.A. 850 (1931).

³⁷ INT. REV. CODE OF 1954, § 453(b).

³⁸ I.T. 2691, XII-1 CUM. BULL. 52 (1933).

[T]here is no express requirement in [the statute] that casual sales of real prop-

tion of what the contract called for, presumably would have compelled a different result in *James McCutcheon & Co.*³⁹ Thus, for example, when a contract calls for full payment "on or before" a date within three years, the sale would qualify under section 453(b) if the seller does not in fact receive more than thirty percent of the selling price in the taxable year of sale. It is irrelevant whether the transaction seeking qualification under section 453(b) is a sale on the installment plan in the sense used with regard to sales by dealers in personalty.⁴⁰ If the initial payments do not exceed the limitation imposed on taxable year-of-sale payments, the sale obviously becomes one in which the purchase price is to be paid in installments⁴¹ whether expressly so provided in the contract or not.

2. *Payments in the Year of Sale—Open Transactions*

In early litigation the Commissioner was successful in denying qualification to sales in which there was no initial payment and the balance was to be paid in a lump sum in a year following the sale.⁴² He also ruled that the statute "fairly implies" that an initial payment of some size is necessary, even when the contract calls for payment in regular installments in subsequent years.⁴³ In the Commissioner's view the statutory statement that the initial payment "not exceed 30 percent of the selling price"⁴⁴ implied that there must be some initial payment. Thus,

erty must constitute what are commonly known as "installment sales" in order to permit the return of income on the installment basis, the only requirement . . . being that the "initial payments" must not exceed [the specified percentage] of the selling price.

G.C.M. 12148, XII-2 CUM. BULL. 58 (1933).

³⁹ 30 B.T.A. 1177 (1934). In a subsequent decision, also involving a sale of securities, certain dividends declared were to be applied toward the purchase price. The Board found that the transaction was eligible under the installment method. E.M. Funsten, 44 B.T.A. 1166 (1941). *McCutcheon* was distinguished as concerned with a sale of personalty by a dealer. In noting this distinction, the Board must have concluded that only sales of personalty by dealers need be on the "installment plan," and that casual sales of personalty and sales of realty qualify simply through compliance with the ceiling on year-of-sale payments. See also Rev. Rul. 56-153, 1956-1 CUM. BULL. 166.

⁴⁰ INT. REV. CODE OF 1954, § 453(a)(1).

⁴¹ Although what actually occurs, and not what the agreement provides or the parties contemplate, should control in determining eligibility under § 453(b), an amount received by the seller cannot be treated as a "payment" unless it appears that the parties "contemplated" that such amount be in partial satisfaction of the selling price. Cf. Frank H. Gilbert, 25 T.C. 81, 87 (1955), *rev'd on other grounds*, 241 F.2d 491 (9th Cir. 1957), where dividends received by a seller of stock were held not to be payments in the year of sale. See also Lewis M. Ludlow, 36 T.C. 102, 108 (1961).

⁴² Thomas F. Prendergast, Ex'r, 22 B.T.A. 1259 (1931).

⁴³ G.C.M. 12148, XII-2 CUM. BULL. 57, 59 (1933).

⁴⁴ INT. REV. CODE OF 1939, ch. 1, § 44(b), 53 Stat. 25 (now INT. REV. CODE OF 1954, § 453(b)(2)(A)(ii)).

a merely nominal payment in the taxable year of sale could have the drastic effect of allowing income to be returned on the installment basis.⁴⁵

Judicial dissatisfaction with the "intrinsic unreasonableness"⁴⁶ of this position induced a statutory change in 1954. The House proposed that amounts received during the first year in which payment is made could not exceed thirty percent of the selling price.⁴⁷ This could leave the status of a transaction uncertain for a number of years after it is consummated and could require significant alteration of the election process. A requirement that election be made contemporaneously with the sale presumably functions far better when qualification can be determined with certainty at that time; but this circumstance often would not have existed under the House proposal. As changed by the Senate, and as finally enacted, the Commissioner's previous administrative stand was abrogated simply by making it clear that qualification would result if there was no payment *or* if the payment did not exceed thirty percent of the selling price.⁴⁸ If the agreement provides for no payment in the year of sale and for the payment of the purchase price in two equal payments in the two following years—a situation found not to qualify under the prior law⁴⁹—the transaction would clearly be eligible. Also, if an agreement to sell property provides that the purchase price is to be paid on or before a certain date within three years after the sale, the transaction would qualify, assuming there is no payment in the year of sale.

If this form of transaction does qualify, however, the selling taxpayer may obtain deferral, even if the buyer pays the selling price in a lump sum on or before the due date. Although this result does not involve the payment of the price in installments, it should not be regarded as shocking, since it falls within the areas in which Congress sought to offer relief through the statute first enacted in 1926. An electing seller should not be charged with payment of a tax liability arising from a property disposition until he has received the consideration with which he can satisfy it. The thrust of the statute, then, is not to require that the contract be of true installment nature, but rather simply that if the pay-

⁴⁵ G.C.M. 12148, XII-2 CUM. BULL. 57, 58 (1933).

⁴⁶ *Gilbert v. Commissioner*, 241 F.2d 491, 493 (9th Cir. 1957), *rev'g* 25 T.C. 81 (1955). *See also* Louis L. Gowans, 26 P-H Tax Ct. Mem. 912 (1957), *on remand from* *Gowans v. Commissioner*, 246 F.2d 448 (9th Cir. 1957).

⁴⁷ H.R. 8300, § 453(b), 83d Cong., 2d Sess. (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 49, A160 (1954).

⁴⁸ INT. REV. CODE OF 1954, § 453(b)(2)(A).

⁴⁹ G.C.M. 12148, XII-2 CUM. BULL. 57, 59 (1933).

ments received in the year of sale are not in excess of thirty percent of the selling price, the tax liability may be returned in the *manner* set out in section 453(a)(1).

It is frequently stated that a taxpayer cannot claim the benefit of section 453 simply because payment on the sale is deferred until a subsequent year.⁵⁰ But this thought has been applied to disqualify transactions only in situations that are not apposite, because they relate to sales by dealers in personalty, with respect to which the statute requires a sale on the installment plan. In one situation the taxpayer, a manufacturer of farm machinery, sold to retail dealers under contracts that provided for payment of the purchase price on the date of sale but not later than a specific date following consignment to the retailer. Finding the transaction ineligible for return under section 453, the Commissioner ruled that an installment plan sale referred to a "transaction by which portions of the same debt are made payable at stated intervals" and not to a situation in which the terms call for "payment at different dates contingent upon later events."⁵¹ This administrative judgment—which is questionable even as it relates to sales by dealers in personalty—must be regarded as having no effect upon the qualification of sales under section 453(b), since in the latter case there is no requirement that the sale in question be made upon the installment plan.

Viewing the ceiling on year-of-sale payments as the *sole* requirement produces difficulties, because it brings "open" transactions of a *Burnet v. Logan* type within the statute.⁵² With regard to such open transactions the statute becomes unworkable. It is not possible to determine either the components of the fraction that spells the quantum of income inclusion (gross profit ÷ total contract price), or the selling price, the latter being essential to learning whether the thirty percent ceiling on year-of-sale payments has been violated. Thus, although the contract apparently need not provide for payments at stated intervals, the very operation of the statute requires knowledge of the total consideration to be paid by the buyer. Although an open-ended transaction may fall

⁵⁰ S. REP. NO. 52, 69th Cong., 1st Sess. 19 (1926), accompanying enactment of the Revenue Act of 1926.

⁵¹ Rev. Rul. 56-587, 1956-2 CUM. BULL. 303, 304. Similarly loose language is used in *Louis Greenspon*, 23 T.C. 138, 155 (1954), *modified*, 229 F.2d 947 (8th Cir. 1956), although the case involved a sale by a dealer in personalty:

Inherent in this position is the inference that every sale made on the credit of the purchaser evidenced by obligations payable periodically is an installment sale. We do not think so. A present sale can be consummated with provision for deferred payment of the consideration and such a transaction is not an installment sale and cannot be reported on the installment basis.

⁵² See note 15 *supra*.

literally within section 453(b), it must be regarded as implicitly outside the section's scope.⁵³

If the transaction is truly open-ended, of course, the seller will almost always prefer to recover his basis in the property sold (even though the payments thereafter will be entirely includible) rather than obtain the more even deferral offered by the installment method. The taxpayer may not have to make this choice in the year of sale. If the Commissioner is subsequently successful in his usual quest to place a value upon the "property" received, it may not be too late for the taxpayer to elect the installment method, assuming the transaction qualifies under section 453(b). Arguably, he has not made an inconsistent election.⁵⁴ Operationally, it is necessary for the total consideration to be known (either as a result of specific statement or through the application of valuation principles) at the time of the transaction with respect to all sales under section 453. It is not necessary, however, nor does the statute require, that the payments be fixed with respect to either time or size of payment.⁵⁵

⁵³ The situations discussed are distinct from those in which payments (in time, amount, etc.) are contingent, but the overall selling price is determinable. Thus, the Commissioner's challenge in *Commissioner v. Brown*, 380 U.S. 563 (1965) (a "bootstrap" property disposition wherein the selling price was to be paid from the profits of the business sold), was aimed at the capital gain treatment sought by the taxpayers and not their claimed eligibility under § 453. See generally Emory & Goldstein, *Federal Income Taxation*, 1965 ANNUAL SURVEY AM. L. 209, 213-16.

There should be no doubt, however, that a specific reference to a total consideration is unnecessary and that valuation of the amount realized (as called for in the Commissioner's admonitory statement in *Treas. Reg. § 1.1001-1(a)* (1957)) can be utilized to effectively "close" the transaction for § 453 purposes.

⁵⁴ See pp. 215-31 *infra*.

⁵⁵ This conclusion is almost inescapable in light of the fact that payments not required by the contract must be considered in determining the level of the initial payment. *E.M. Funsten*, 44 B.T.A. 1166 (1941); *Wagegro Corp.*, 38 B.T.A. 1225 (1938). See *Lewis M. Ludlow*, 36 T.C. 102, 108 (1961):

It is not necessary for the sale to conform to the popular conception of an installment sale with a contract calling for the payment of the purchase price in fixed installments, for the casual seller to return income on the installment basis. See also *G.C.M.* 1162, VI-1 CUM. BULL. 22, 23 (1927). The Commissioner apparently takes the position that a sale will not be eligible under § 453(b) if the seller can receive the balance owed upon demand. *Rev. Rul. 55-694*, 1955-2 CUM. BULL. 299. A contrary result would unreasonably hinder the application of constructive receipt principles. However, a right to receive all cash that falls short of being a part of the agreement between the parties, but that takes the form of an offer by the buyer to pay the entire amount in cash, should not prevent qualification under § 453, if the transaction is subsequently consummated (even at the seller's request) under circumstances in which the seller receives less than 30% cash in the year of sale. *Charles A. Collins*, 48 T.C. 45 (1967); *Lewis M. Ludlow*, 36 T.C. 102, 107 (1961); cf. *Rev. Rul. 56-20*, 1956-1 CUM. BULL. 197. Although an agreed withholding of amounts by the buyer in an effort to effect qualification under

3. Sale of Appreciated Property in Return for an Annuity

The Commissioner takes the position that a sale of appreciated property to a corporation or foundation in return for a private annuity constitutes a gain-realizing event in the year the transfer is made, with the amount realized being the present value of the payments to be made under the annuity contract.⁵⁶ Thus, taxpayers naturally are quite willing to trade contemporaneous recognition under section 1001 for deferral under section 453. Yet, the Commissioner reportedly takes the position that the transferring taxpayer cannot employ section 453, because the statute contemplates that a fixed amount be received.⁵⁷ It seems strange that the Commissioner is so willing to use valuation principles to determine gain realization under section 1001 but that this value cannot be employed to find the total contract price under section 453. In a potentially "open" transaction that is "closed" by reason of the successful valuation of the amount realized, income deferral through the use of section 453 should be available.

The Commissioner's position may be justified, however, because of certain unique features in the private annuity situation. If the annuity is for the lifetime of the transferor and without a survivorship feature, his early death may result in the escape from taxation of a large part of the appreciation that contemporaneous recognition and inclusion in income would have caught. Unlike the usual sale of property in which the obligor is bound to make payments after the decedent's death (and in which section 1014(c) prevents a basis step-up obliterating the deferred gain), the consideration in the annuity situation is snuffed out upon the

§ 453 will probably be valid, the use of an escrow as a depository for the balance can result in constructive receipt, if the amounts are unconditionally paid by the buyer and there is some evidence to show that the amounts were paid into escrow at the request of the seller. *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955); *Rhodes v. United States*, 243 F. Supp. 894 (W.D.S.C. 1965); *Williams v. United States*, 185 F. Supp. 615 (D. Mont. 1960). An expansive application of the doctrine of constructive receipt compelled a surprising disqualification of an installment sale in *Everett Pozzi*, P-H TAX CT. REP. & MEM. DEC. ¶ 49.14 (1967). *But cf.* *Rebecca J. Murray*, 28 B.T.A. 624 (1933) (receipt of the escrow funds was conditioned upon the taxpayer refraining from entering a competing business for a stated period of time); *Wilson & Fields*, 31 P-H Tax Ct. Mem. 1189 (1962), where the circumstances of the escrow were also such that constructive receipt was not found. The *Wilson & Fields* court found the intention of the parties was to treat the preferred stock in buyer corporation, which was placed in escrow, as mere security for the price remaining unpaid. The escrow requirements placed on the stock by the commissioner of Corporations limited the market for those securities and negated their equivalence to cash.

⁵⁶ Rev. Rul. 62-136, 1962-2 CUM. BULL. 12.

⁵⁷ *I.R.S. Says Installment Rule Not Applicable to Annuity*, 27 J. TAXATION 63 (1967); *cf. Installment Sale Possibilities in Gifts to Charity*, 26 J. TAXATION 127 (1967); *Installment Sale as Annuity in Gifts to Charity*, 26 J. TAXATION 254 (1967).

decendent's death. Under such circumstances use of section 453 could leave only part of the realized gain taxable. The situation also presents the problem of meshing the deferral of the pre-transfer appreciation under section 453 with the inclusion of the post-transfer income generated by the annuity under section 72.

B. Is the Transaction a "Sale or Other Disposition"?

Besides the need for an installment feature, a transaction must constitute a "sale or other disposition," and, in the case of personalty, a "casual"⁵⁸ sale or disposition, in order to qualify under section 453(b). Fortunately, this is familiar phraseology and has frequently been the subject of judicial scrutiny.⁵⁹

State law technicalities, which might bear upon the existence of a "sale," may become irrelevant in seeking uniform construction of a federal statute.⁶⁰ Lease or purchase transactions, which must be labeled for tax purposes when the transaction occurs, have produced much controversy in other contexts.⁶¹ Naturally, eligibility for the installment method must await a determination of whether the transaction constitutes a taxable disposition at all.⁶² Thus, a taxpayer who receives cash

⁵⁸ With regard to what constitutes a casual sale of personalty, see pp. 265-67 *infra*.
⁵⁹ *E.g.*, Commissioner v. Brown, 380 U.S. 563, 570-71 (1965):

A "sale" . . . is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code.

⁶⁰ Locally created relationships are, of course, the focus of the federal income tax; but when it is found that the transaction entered into is of the type Congress intended to tax, it is of no consequence that local law calls for a varying classification. See generally Stephens & Freeland, *The Role of Local Law and Local Adjudications in Federal Tax Controversies*, 46 MINN. L. REV. 223, 224-26 (1961).

⁶¹ See Comment, *Federal Income Tax Treatment of Equipment Lease-or-Purchase Agreement*, 52 VA. L. REV. 1336 (1966).

⁶² Of course, a finding that the transaction is a lease rather than a purchase prohibits utilization of the installment method. Rev. Rul. 58-281, 1958-1 CUM. BULL. 235; Rev. Rul. 56-498, 1956-2 CUM. BULL. 300; I.T. 1819, II-2 CUM. BULL. 73 (1923).

It was recognized early that title passage is not an essential ingredient of a sale or disposition qualifying under § 453. In Charles J. Derbes, 24 B.T.A. 276, 283 (1931), the Board stated:

Those provisions do not require that title pass when the initial payments are made. In most installment sales, title does not pass with the initial payments Of course, title must pass eventually in order to have a sale or other disposition, but there is nothing to indicate that title did not pass eventually [here]. . . . If a sale falls through after some income has been reported, some adjustment becomes necessary

The regulations manifestly permit title retention as a security device. Treas. Reg. § 1.453-2(a), T.D. 6682, 1963-2 CUM. BULL. 198; Treas. Reg. § 1.453-4(a) (1958). Though the Commissioner views income from construction contracts as ineligible for return under § 453, Rev. Rul. 59-345, 1959-2 CUM. BULL. 136, analogous deferral of income is available through

and notes in a transaction involving the assignment of drilling rights on oil and gas properties cannot obtain deferral of the contemporaneous tax impact if the arrangement between the parties is found to be a lease.⁶³ This result follows, of course, regardless of whether the amounts to be received take the form of royalties or of oil payments.

But what if the taxpayer sells the right to the royalties or oil payments? If the entire right to the royalties or oil payments is sold, the transaction presumably would qualify not only as a sale, but also for capital gain treatment.⁶⁴ But suppose only a fixed amount is carved out in dollars from the royalties or oil payments and only that part is sold. Despite the Commissioner's contention that the transmittal of such an interest constitutes an anticipatory assignment of income (and thus that the entire amount received by the transferring party was ordinary income), a court of appeals has found that the transaction was in fact a sale and, since less than thirty percent of the selling price was received in the taxable year of sale, eligible for return under section 453.⁶⁵

What effect has the subsequent decision of *Commissioner v. P. G. Lake, Inc.*,⁶⁶ which drastically altered the landscape of the capital gains and assignment of income areas, upon the disposition of property interests that, had the sale or disposition not taken place, admittedly would have produced ordinary income to the transferor? The Court in *Lake* found the lump sum consideration received by the transferor to be ordinary income, because it was simply "a substitute for what would otherwise be received at a future time as ordinary income."⁶⁷ But the decision proceeded on the basis "that oil payments are interests in land."⁶⁸ Thus, as viewed by the Court, the problem in *Lake* stemmed from the inadequacy of the capital gain definition in the statute and not from whether the transfer was a gain-realizing event. The Court concluded that since the interest conveyed was "fruit" (utilizing the "fruit-tree" metaphor), it could not be classed as "property" for capital gains purposes.⁶⁹ This manipulation of the "property" concept was felt neces-

use of the administratively authorized percentage-of-completion and completed-contract methods. Treas. Reg. § 1.451-3 (1957).

⁶³ *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961); *Harry Leland Barnsley*, 31 T.C. 1260 (1959). A cash basis taxpayer may thus be taxed, in the year of the agreement's execution, on the fair market value of the amounts received, including notes that may call for payment over a period of many years subsequent to the agreement.

⁶⁴ I.T. 4003, 1950-1 Cum. BULL. 10; Rev. Rul. 55-526, 1955-2 Cum. BULL. 574.

⁶⁵ *Caldwell v. Campbell*, 218 F.2d 567 (5th Cir. 1955).

⁶⁶ 356 U.S. 260 (1958).

⁶⁷ *Id.* at 265.

⁶⁸ *Id.* at 264.

⁶⁹ *Id.* at 266-67. See generally Del Cotto, "Property" in the Capital Asset Definition:

sary to protect the integrity of the capital gains statute. It should not be regarded as relevant to questions arising under section 453.

If the transfer of such interests is classed as a "sale or other disposition" of property, the resulting eligibility to use section 453 will not result in preferential treatment of the selling taxpayer. If the taxpayer retained the oil payments, amounts received pursuant to the agreement would be ordinary income when received (or when accrued, if the taxpayer employs the accrual method). If a payment carved out of a larger interest is sold pursuant to an agreement calling for periodic payments of the selling price, the deferral resulting from election of the installment method will place the taxpayer (insofar as the timing of his income is concerned) in precisely the same posture as if the oil payment had been retained. Of course, even though the Commissioner would have difficulty denying that the transfer of such an interest constitutes a sale or other disposition within section 453(a), he may seek to label the transaction as a disposal of an "income" and not of a "property" right. Although this distinction has been employed successfully,⁷⁰ it has been used to deny capital gains treatment to contract rights that would have produced ordinary income if retained.⁷¹

Although the "property status" question is relevant to the attainment of the legislative goals that prompted enactment of the capital gains provisions, such nice distinctions have no place in the consideration of section 453. Surely, the contractual interests in question, though productive of ordinary income, constitute property in the legal sense. It is this error of reasoning into which the Tax Court fell in *Charles E. Sorensen*.⁷² The taxpayer sold options to purchase stock in his employer, which he had received as compensation at the time of his employment agreement. The court held that the proceeds realized from the sale pro-

Influence of "Fruit and Tree," 15 BUFF. L. REV. 1 (1965); Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293 (1962).

⁷⁰ Del Cotto, *supra* note 69, at 33-59; see Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1 (1964).

⁷¹ In situations involving the cancellation or termination of a contractual arrangement, the Commissioner (and some courts) have found the "sale or exchange" requisite lacking, thus rendering the capital gains provisions inapplicable. Del Cotto, *supra* note 69, at 42-46. Although the better reasoned opinions seem to decide the sale or exchange issue in the taxpayer's favor, e.g., *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962), even contrary judicial sentiment should not form a basis for denying the transferring taxpayer the opportunity to utilize § 453 in similar situations. While it is at least arguable that "sale" treatment should be denied, since the extinguishment of the transferor's rights leaves nothing in the hands of the transferee, the transaction seems to constitute a "disposition" and thus falls within the larger group of property disposals potentially eligible under § 453.

⁷² 22 T.C. 321 (1954).

duced ordinary income rather than capital gain. In rejecting the taxpayer's contention that the proceeds were eligible for treatment under section 453, the court muddled the waters.

Since the sales of the options operated to compensate petitioner for his services, what he received in the form of both cash and notes was income by way of compensation. The provisions of section 44 [now section 453] relate only to the reporting of income arising from the sale of property on the installment basis. Those provisions do not in anywise purport to relate to the reporting of income arising by way of compensation for services.⁷³

To deny that the options sold by the taxpayer constituted property seems unsound. Ordinary income—into which the proceeds of this transaction were converted by principles more eloquently expressed in the later decision of *Commissioner v. P.G. Lake, Inc.*—is equally eligible for the deferral allowed by the installment method. Only by stripping the contract interest of the “property” label and placing in its stead the “compensation” tag was the court able to reach this dubious result.⁷⁴

⁷³ *Id.* at 342.

⁷⁴ The Tax Court has made the same error elsewhere. In *Leonard Hyatt*, 30 P-H Tax Ct. Mem. 1789, 1806 (1961), the court, using a “substitute for future income” rationale, found that the assignment of an insurance agency management contract produced ordinary income. It then jumped to the conclusion that “[i]nasmuch as the . . . amount was a substitute for compensation . . . it is clear that the installment sales provisions . . . are inapplicable.” *Id.* See also *Gerald B. O'Neill*, 33 P-H Tax Ct. Mem. 7 (1964). To the extent that Rev. Rul. 55-374, 1955-1 CUM. BULL. 370, hints that eligibility under § 453 with regard to sale of a distributorship agreement is somehow tied to the conclusion that the property disposed of is a capital asset, it should be disregarded.

In *Estate of Scharf v. Commissioner*, 316 F.2d 625, 630 (7th Cir. 1963), the court found that ordinary income resulted from the sale (to third parties) of membership certificates in a charitable hospital by doctor-members, and that it served as a basis for denying § 453 eligibility, because there was no “sale or other disposition.” The error here (and in *Charles E. Sorensen*) indicates a judicial reluctance to recognize that the installment method has possible application to any event that is gain realizing within § 1001.

Prior to the 1954 Code, and with the growth of the entity concept, the conclusion that the sale of a partnership interest was eligible for return under the installment method was easy to reach. *B.P. Bailey*, 18 B.T.A. 105 (1929). With the codification of this concept in INT. REV. CODE OF 1954, § 741, one could properly assume that the sale of such an interest would continue to qualify as a casual sale of personalty within § 453(b). *Woolsey v. United States*, 208 F. Supp. 325 (S.D. Tex. 1962), *rev'd on other grounds*, 326 F.2d 287 (5th Cir. 1963). The fragmentation of the selling price compelled by §§ 741 and 751 is designed to prevent the conversion of ordinary income into capital gain and should not be viewed as triggering the application of § 453(b)(1)(B), which has the effect of prohibiting qualification of inventory as the subject matter of a casual sale of personalty.

Presumably, an award for the involuntary conversion of property is potentially eligible for return under § 453, though it may constitute ordinary income. *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960). The opposite result is obtained,

Although former President Truman was unable to obtain capital gain treatment upon the sale of his manuscript (unlike former President Eisenhower, who was more fortunate),⁷⁵ the Commissioner ruled that the transaction constituted a sale and was eligible for return under section 453.⁷⁶ He properly concluded that the manuscript was "property" (even though it could have produced ordinary income if not sold outright) and eligible for return under section 453 upon its disposition, even though section 1221(3) required that the gain be treated as ordinary income. This represents a proper approach. The property-income rights dichotomy, evolved by the judiciary to meet the inadequacy of the capital gains definition, should not be allowed to becloud the entirely separable question whether the transaction is eligible under section 453.⁷⁷

C. *Utilization When Complete or Partial Nonrecognition Is Available*

With regard to transactions that are clearly sales, the existence of a provision allowing complete or partial nonrecognition should not prohibit the application of another provision that provides for deferral of realized gain. Thus, if a taxpayer sells his residence (basis, \$25,000) for \$30,000 and acquires a new residence for \$28,000 within the time provided in section 1034, the realized gain of \$5,000 is insulated by the nonrecognition effect of the statute, with the result that only \$2,000 is presently recognized. If the selling taxpayer does not receive more than thirty percent of the selling price of the old house in the taxable year of sale, the gain recognized as a result of section 1034 should be eligible for

however, with respect to proceeds from use and occupancy insurance that are treated not as the proceeds of an involuntary conversion, Treas. Reg. § 1.1033(a)-2(c)(8) (1957), but rather as profits allocable to, and deemed accrued in, the period during which the loss was sustained. *Cappel House Furnishing Co. v. United States*, 244 F.2d 525 (6th Cir. 1957).

⁷⁵ B. BITTKER, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 416-17 (3d ed. 1964).

⁷⁶ Rev. Rul. 234, 1953-2 CUM. BULL. 29. The ruling refers to the fact that the taxpayer was not an "author by profession," but does not seem to rely on this fact in support of its conclusion. It remains an open question whether professional authors would be prohibited from using § 453(b) on the grounds that they are regularly engaged in selling property of this nature.

⁷⁷ Although unharvested crops are presently eligible for capital gains treatment under certain circumstances, INT. REV. CODE OF 1954, § 1231(b)(4), a finding, under prior law, that their disposition produced ordinary income did not prohibit the attainment of § 453 eligibility. *Ann Edwards Trust*, 20 T.C. 615, 618 (1953), *aff'd per curiam*, 217 F.2d 952 (5th Cir.), *cert. denied*, 349 U.S. 905 (1955). If the property is of an inventory nature and if the taxpayer is not engaged in selling on the installment plan within § 453(a), he may be forced to take the position that it is realty. The *Edwards* court refused to classify unharvested crops as personalty or realty, finding qualification under § 453(b) in either event.

optional deferral under section 453. Thus, if the sales agreement provided for the payment of \$5,000 in the year of sale, and an equal amount in each of the five succeeding years, the taxpayer would report \$333.33 as income in the year in which the transaction occurred ($\$5,000 \times \$2,000 \div \$30,000$).⁷⁸

This result is not exactly clear from the statute itself, since section 453(a) speaks of gross profit to be "realized" on the transaction without specifically referring to the possibility that some or all of the realized gain may not be recognized. Taking the statute literally in such situations, however, would render the various nonrecognition provisions ineffective whenever the taxpayer seeks to defer his gain through use of the installment method. Surely such ill effects were never meant to flow from the method's use. Consequently, if a taxpayer qualifies for nonrecognition through an exchange of business property for property of like kind,⁷⁹ any gain recognized as a result of the receipt of recognition property (*e.g.*, cash) is eligible for return under section 453,⁸⁰ provided, of course, the seller does not receive more than thirty percent of the selling price (exclusive of evidences of indebtedness of the purchaser) in the year of the sale or disposition.

Many "like-kind" exchanges, which also involve the receipt of recognition property, will not be eligible for return under section 453, since the receipt of the nonrecognition property must also be considered as payment within section 453(b)(2)(A).⁸¹ Thus, if a taxpayer transfers property (basis \$10,000) to a corporation in return for stock worth \$50,000, a note calling for the payment of \$10,000 in each of the four succeeding years, and for cash of \$10,000, he will be in a position to obtain nonrecognition for a portion of his realized gain of \$90,000, assuming he complies with the control requirement.⁸² Assuming the note issued by the corporation does not qualify as "stock or securities," the recognized gain will be limited to \$50,000. It will be subject to full return in the year of sale, however, because the taxpayer received, in stock and cash, more than thirty percent of the selling price. If, instead, the taxpayer had received stock worth \$15,000, cash in the amount of \$5,000, and an installment note calling for the payment of \$20,000 annually for the four years succeeding the year of sale, the recognized gain of \$85,000 would be eligible for return under section 453.

⁷⁸ Rev. Rul. 75, 1953-1 CUM. BULL. 83.

⁷⁹ INT. REV. CODE of 1954, § 1031.

⁸⁰ Rev. Rul. 65-155, 1965-1 CUM. BULL. 356.

⁸¹ The value of the like-kind property is used in computing the "selling price" and treated as a payment in the year of sale. Clinton H. Mitchell, 42 T.C. 953, 965 (1964).

⁸² INT. REV. CODE of 1954, §§ 351(a), 368(c).

Thus, a proper election under that section would defer until succeeding years all but \$17,000 of the gain recognized on the transaction (\$20,000 x \$85,000 ÷ \$100,000).

D. *Use in Transactions Involving a Corporation-Shareholder Relationship*

A prolonged inquiry into whether a transfer to a controlled corporation that qualifies for nonrecognition under section 351 constitutes a "sale" is unnecessary, since it certainly qualifies as a property "disposition."⁸³ The same is true of property transferred pursuant to a corporate reorganization. It is not mere coincidence that both section 1001 and section 453 employ language such as "sale or other disposition." Congress may be viewed as intending to grant potential eligibility under section 453 to all transactions that are gain-generating under section 1001. Section 1002 provides that the separately operating nonrecognition provisions are superimposed upon the general realization principles. The terminology "sale or exchange" in sections 1001(c) and 1002 has its roots, no doubt, in the reorganization provisions, and presently evinces a Congressional intent to bestow nonrecognition upon a smaller circle of transactions than are generally considered gain (or loss) producing under section 1001(b).⁸⁴ Thus, any exchange qualifying for nonrecognition is a fortiori within the phrase "sale or other disposition." Although they are far more complex, the reorganization provisions "are an analogue or extension of section 1031."⁸⁵ The Commissioner has specifically approved application of the installment method under section 1031.⁸⁶ Suppose, therefore, that in a Type "D" reorganization⁸⁷ the tax-

⁸³ Some commentators believe that the installment method may not be available with respect to gain recognized in a § 351 transfer. Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX. L. REV. 1, 53-54 (1960); Paul & Kalish, *Transition from a Partnership to a Corporation*, N.Y.U. 18TH INST. ON FED. TAX. 639, 650 (1960). But see Harry F. Shannon, 29 T.C. 702, 719 (1958), where the taxpayer's belated effort to qualify the transaction under § 351, in an attempt to avoid the application of § 453(d), was rejected by a finding that the transfer was a "sale." The court indicated, however, that § 453 may well have been applicable even in a § 351 situation.

Although it seems far more reasonable to assume that § 351 transactions are eligible for return under § 453, nonapplicability of § 351 does not insure that the transaction is a "sale"; the transaction may in reality be a contribution to capital, with a simultaneous nonliquidating distribution. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 103-04 (2d ed. 1966).

⁸⁴ See Note, *The Elements of a Section 117 "Sale or Exchange"*, 53 COLUM. L. REV. 976, 977 (1953).

⁸⁵ B. BITTKER & J. EUSTICE, *supra* note 83, at 498.

⁸⁶ Rev. Rul. 65-155, 1965-1 CUM. BULL. 356.

⁸⁷ INT. REV. CODE OF 1954, § 368(a)(1)(D).

payer, a ten percent shareholder in the transferor corporation, receives a five-year installment note instead of stock in the transferee corporation. If the other shareholders receive stock instead of "other property," thereby supplying the necessary continuity of interest, gain realized under section 1001 would be subject to recognition by operation of section 356(a)(1), and to possible treatment as a dividend under section 356(a)(2). There is no apparent reason, however, why the opportunity for deferral of the recognized gain under section 453 should not be available.⁸⁸ Qualification under section 453 will not occur frequently, because satisfaction of the continuity-of-interest requirement will most often result in the taxpayer's receipt of "payment" (*i.e.*, stock in the acquiring corporation) in excess of the thirty percent requirement of section 453(b)(2)(A)(ii). Nevertheless, it is error to suggest that gain recognized in a corporate reorganization should not at least initially be eligible for the deferral provided by the statute.⁸⁹

Obviously, therefore, gain recognized to a taxpayer as a result of a partial liquidation⁹⁰ or a redemption of stock⁹¹ should be similarly endowed with potential eligibility under section 453. The statute provides nondividend treatment for certain qualifying corporate distributions through the description of such payments as being "in exchange for the stock."⁹² The philosophy behind this legislative mutation is that such transactions more nearly resemble a "sale" than a "dividend." Thus, if a taxpayer's interest in a corporation is terminated through a redemption of stock that qualifies under section 302(b)(3), he should be able to report the recognized gain by the installment method, assuming he does not receive more than thirty percent of the "selling price" (exclusive of

⁸⁸ Conceptually, such transactions should be treated as qualifying dispositions within § 453, though in the instance posed the Commissioner may argue that the obligation received by the distributee shareholder is not "of the purchaser" within § 453(b)(2)(A)(ii). *Cf. Mercedes Frances Freeman Trust*, 36 T.C. 779 (1961), *aff'd*, 303 F.2d 580 (8th Cir. 1962).

⁸⁹ *Frances M. Averill*, 37 B.T.A. 485, 491-93 (1938), *rev'd on other grounds*, 101 F.2d 644 (1st Cir. 1939); BNA TAX MANAGEMENT PORTFOLIO 48-2d, INSTALLMENT SALES, at A-22 (1966); Frost & Burns, *Current Tax Problems While Operating as a Corporation*, U. So. CAL. 1958 TAX INST. 117, 145-46. *But. cf. Leake, Problems in Corporate Acquisitions*, 13 TAX L. REV. 67, 84 (1957).

⁹⁰ INT. REV. CODE OF 1954, § 346.

⁹¹ INT. REV. CODE OF 1954, § 302.

⁹² INT. REV. CODE OF 1954, §§ 302(a), 331(a)(2). The presence of express administrative authorization to employ § 453 in reporting the ordinary income generated (as a result of § 1248) through a liquidation of a controlled foreign corporation or the redemption of its stock supports the conclusion that the method is applicable in similar situations involving domestic corporations. Treas. Reg. § 1.1248-1(f) (1964). Its absence in the older regulations under §§ 302 and 331 can be attributed to a recently burgeoning indulgence in "administrativese."

evidences of indebtedness) in the taxable year of sale.⁹³ If the distribution is not within one of the safe redemption corridors, however, the installment method is unavailable. In such instances the statute deprives the transaction of its exchange status and treats it as a distribution, a tax event plainly not within the phrase "sale or other disposition."⁹⁴ So categorized, the fair market value of property distributed (including evidences of indebtedness) is taxable as ordinary income in the year of distribution to the extent of earnings and profits.⁹⁵ Again, if a corporation completely liquidates, qualifying under section 337, and the distribution of the assets of the corporation (*e.g.*, cash and unsold property) is accomplished during a twelve-month period that straddles two taxable periods of the shareholder, the gain recognized on the transaction, and given exchange treatment by section 331, would be eligible for deferral under section 453, assuming its requirements are satisfied.

Assume now that a corporation, seeking qualification under section 337(a), sells its assets to another corporation primarily in return for notes. Pursuant to a plan of liquidation, the selling corporation distributes these notes and its remaining assets to its shareholders, who will be subject to section 331(a)(1), which imposes "exchange" treatment upon the transaction.⁹⁶ Thus, the shareholders will be subject

⁹³ See *Jolley v. United States*, 246 F. Supp. 533 (D. Nev. 1965), involving an acquisition by a corporation of its own shares. Apparently the transaction fell within a safe redemption corridor; the parties stipulated that the only issue was whether the taxpayer had made a proper election under § 453. See ABA TAXATION SECTION ANN. REP. 32 (1960). There also seems to be some latitude concerning the form of evidences of indebtedness received by the shareholders, with bonds constituting a useful and apparently proper form. Cf. *Thomas F. Prendergast, Ex'r*, 22 B.T.A. 1259 (1931), where the installment method was rejected because the bonds called for a single payment, and not because of the form of payment. Although a lump sum amount paid in a year subsequent to the year of sale would seem to fall literally within § 453(b), caution probably dictates that the indebtedness be paid in more than one installment.

Reportedly, the Commissioner has ruled privately that convertible debentures are not "evidences of indebtedness" within § 435(b)(2)(A)(ii), but he did not bar the way for a change of position after further study. BNA, TAX MANAGEMENT MEMO 67-12, RESTORATION OF INVESTMENT CREDIT AND ACCELERATED DEPRECIATION (1967).

⁹⁴ INT. REV. CODE of 1954, § 302(d) provides that a redemption of stock that fails to come within one of the safe redemption corridors "shall be treated as a distribution of property to which § 301 applies." Although the redeemed shareholder apparently has "disposed" of his stock, the distribution treatment called for by § 302(d) still cannot be ignored. Thus, any distribution of property made by a corporation to a shareholder with respect to its stock probably will be ineligible for § 453 treatment unless it is given "exchange" treatment by another section of the statute. INT. REV. CODE of 1954, §§ 301(a), (c).

⁹⁵ INT. REV. CODE of 1954, §§ 301(c)(1), 316(a).

⁹⁶ INT. REV. CODE of 1954, § 453(d)(4)(B) provides generally that the distribution of the installment obligations will not be a gain recognizing event.

to a tax in the year of distribution upon an amount equal to the difference between the basis in their stock and the fair market value of the property received in the liquidation distribution. Note, however, that if the tax is imposed in the year of distribution the shareholders will be without resources from the distribution itself to pay the tax, their chief possession being the notes of the buying group. This situation is strikingly close to what compelled the enactment of section 453. Are the taxpayers able to defer the tax impact until the receipt of property with which to satisfy the obligation? Although it was concluded above that the property is received by the distributee shareholders in a transaction that is a "sale or other disposition,"⁹⁷ another facet of the statute prohibits deferral under section 453. While evidences of indebtedness are not considered payment within the taxable year of sale for the purpose of applying the thirty percent test in section 453(b)(2)(A)(ii), the statute specifically states that only the indebtedness "of the purchaser" is so excluded. Since section 331 bestows exchange treatment upon the liquidating distribution, the "purchaser" is the liquidating corporation, not the obligor on the evidences of indebtedness. The result is that the indebtedness must be considered "payment," and therefore section 453(b)(2)(A)(ii) cannot be satisfied. Thus, whereas business advantages may accrue to the buyer as a result of an asset acquisition on the installment basis, there appear to be possible tax disadvantages to the shareholders of the selling corporation.⁹⁸

⁹⁷ INT. REV. CODE OF 1954, § 331(a)(1).

⁹⁸ The *Court Holding* doctrine continues to present problems outside of § 337, concerning corporate liquidations designed to place the assets in the hands of the shareholders at a fair market value basis (INT. REV. CODE OF 1954, § 334(a)) and thereby to effect an installment sale to the buying group. B. BITTKER & J. EUSTICE, *supra* note 83, at 386-92. The use of a one-month liquidation (INT. REV. CODE OF 1954, § 333) providing for nonrecognition upon liquidation, except to the extent of accumulated earnings and profits, may be one way to make the installment method available to the selling group. A.B.A. TAXATION SECTION ANN. REP. 30 (1957). This is not a panacea, since § 337 has no application; thus, the shareholders, lest a corporate tax be imposed upon the asset disposition, will be forced to walk the tightrope between the *Court Holding* and the *Cumberland Public Service* doctrine. B. BITTKER & J. EUSTICE, *supra* note 83, at 407.

Under certain circumstances an election under Subchapter S (INT. REV. CODE OF 1954, §§ 1371-78) can preserve the installment method for the recipient shareholders. An asset sale by the electing corporation on the installment method will allow the computation of the corporation's income on that basis and the pass-through of the privilege to the shareholders. Rev. Rul. 65-292, 1965-2 CUM. BULL. 319. It must be assumed, however, that the election has been in effect for 3 years; otherwise a partial tax on capital gains would be imposed at the corporate level, generating a dual tax effect that might be less desirable than a liquidation qualifying under § 337. Also, if the assets sold produce ordinary income, § 337 may be a more advantageous route, providing nonrecognition at the corporate level and capital gain treatment for the shareholders, while Subchapter S would cause a pass-through of such ordinary items.

When, with a swift stroke, the Tax Court reached this result in *Mercedes Frances Freeman Trust*,⁹⁹ legislative change clearly became the only means for securing a reasonable equality—with respect to the timing of the tax impact on the shareholders—between the sale of assets qualifying under section 337 and a sale of stock by the shareholders. If the shareholders dispose of their stock in return for notes of the purchaser, the notes are not considered payment in the year of sale, and the way is opened for income deferral under section 453. Further, if the purchaser is a corporation, a liquidation of the acquired corporation that qualifies under section 334(b)(2) will give the purchaser a cost basis in the assets received equal to the purchase price of the stock.

The Section of Taxation of the American Bar Association has responded with a proposed amendment to section 331 designed to meet the problem.¹⁰⁰ The proposal would enable shareholders to elect the installment method with respect to the third-party obligations that they receive as a result of the liquidation of the selling corporation. The problem present in *Freeman Trust* is removed by a proposed statutory declaration that the evidences of indebtedness received by the shareholders shall be treated as being the obligation of one person—to accommodate the situation where the assets are sold to more than one buyer—and that the one person shall be treated as the purchaser of the stock. With these fictions, the proposed statute throws the transaction into section 453(b). If it passes muster there,¹⁰¹ the desired deferral is obtained. The proposal does not, however, treat all the assets distributed by the liquidating corporation as potentially eligible for return under section 453. In effect, it carves out a portion of the assets received by the distributee shareholder as a separable asset package which can be applied against the framework of section 453(b). The protective mantle is placed only on evidences of indebtedness that are received pursuant to a sale qualifying for nonrecognition within section 337(a), and only if all the assets required to be distributed by 337(a) are in fact distributed by the liquidating corporation within one taxable year of the distributee shareholder. Thus, the distribution of evidences of indebtedness that were acquired in a sale of assets prior to the adoption

⁹⁹ 36 T.C. 779 (1961), *aff'd*, 303 F.2d 580 (8th Cir. 1962). See also Leonard S. Krause, P-H Tax Ct. Rep. & Mem. Dec. ¶ 67,068 (1967).

¹⁰⁰ ABA TAXATION SECTION ANN. REP. 50-54 (1967).

¹⁰¹ I.e., if the property (other than the evidences of indebtedness of the "purchaser") received by each shareholder in the taxable year of sale does not exceed 30% of the selling price of his stock.

of the plan of liquidation¹⁰² would be considered payment for the purposes of the thirty percent rule of section 453(b)(2)(A)(ii), and could possibly disqualify the entire transaction under section 453.

The installment method is made available to the shareholder only if the section 337(a) distribution, including evidences of indebtedness, is accomplished within a single taxable year of the shareholder.¹⁰³ This time limit, which is distinct from the mandate at the corporate level requiring complete distribution within a twelve-month period, is thought necessary to allow an effective decision concerning whether the assets received during that period are eligible under section 453(b). If the corporation's twelve-month distribution period straddles two taxable periods of the shareholder, he would presumably not be able to conclude with certainty whether the amounts received in his taxable year of sale were within the thirty percent ceiling. Although the Commissioner has announced a policy requiring the valuation of property received in the year of sale, "open" liquidations are relatively common.¹⁰⁴ The taxpayer's contention that the liquidation is "open" may indicate his choice of deferral technique, but the isolation of the assets eligible for return under section 453 into one taxable period of the shareholder appears to be an orderly manner in which to make the installment method available. If the twelve-month distribution period required by section 337(a) straddles two taxable periods of the shareholder, the actual distribution of the property in the second taxable period can result in a larger asset group potentially eligible under section 453(b).¹⁰⁵ Thus, a subsequent distribution from a reserve permissibly retained under section 337(a)(2) for the payment of claims will be ineligible for section 453 treatment and therefore taxable when received.¹⁰⁶

If a liquidating distribution consists of a substantial portion of unsold assets or cash, the distributee shareholders will not be able to meet the requirements of section 453(b). Unless the fair market value of the liquidation distribution made during the shareholder's taxable

¹⁰² For example, a corporation may do this to obtain loss recognition from a sale of a portion of its assets prior to the commencement of the nonrecognition period.

¹⁰³ ABA TAXATION SECTION ANN. REP. 50-54 (1967).

¹⁰⁴ B. BITTKER & J. EUSTICE, *supra* note 83, at 345-46.

¹⁰⁵ Also, where the 12-month period under § 337 overlaps two taxable years of the shareholder, this provision is thought desirable to prevent attempted circumvention of the 30% down payment ceiling by distributing evidences of indebtedness in one year and cash in another year when the cash would exceed 30% of the total.

ABA TAXATION SECTION ANN. REP. 53 (1967).

¹⁰⁶ See example, *id.* at 54.

year consists of evidences of indebtedness that have a value of at least seventy percent of the total amount distributed, the distributee shareholder will find the installment method unavailable even though a significant portion of the property received by him is not readily available as a source from which to pay the tax. This may limit the usefulness of the proposal, but if carefully employed it can remove many of the inequities that result from the present statutory pattern.

E. *Ersatz Capital Gains*

The installment method should be available in any transaction that is gain-realizing within section 1001.¹⁰⁷ A fortiori, this should include the instances in which Congress, having succumbed to the constant quest for preferential treatment, has granted ersatz capital gains treatment. A common device has been to confer the "sale or exchange" mantle by statute upon certain "ambiguous transactions."¹⁰⁸ Thus, a gain recognized from the involuntary conversion of section 1231 property should be eligible for return under section 453, if the requisites of that section are met.¹⁰⁹ The same can be said with respect to the retirement of certain bonds and evidences of indebtedness¹¹⁰ and with respect to situations within the so-called "Louis B. Mayer provision," which bestows capital gain treatment upon certain amounts received by employees on termination of long term employment contracts.¹¹¹

Certain instances within the network of ersatz capital gains probably are not eligible under the installment method. For example, an election under section 631(a) has the effect of treating the cutting of

¹⁰⁷ The statute itself, stating that "income" may be returned on the installment method, seems to preclude the return of losses on installment sales by this method. There is ample and long-standing judicial authority to support this reading. *Sacks v. Burnet*, 66 F.2d 223 (D.C. Cir. 1933); *Martin v. Commissioner*, 61 F.2d 942 (2d Cir. 1932), *cert. denied*, 289 U.S. 737 (1933). See also I.T. 2063, III-2 CUM. BULL. 108 (1924). Thus, determinable losses are deductible only in the year of sale.

¹⁰⁸ *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 250 (1941).

¹⁰⁹ However, in netting § 1231 transactions, only the amount recognized in the taxable year as a result of the election to use § 453 (*i.e.*, the income portion of the payment received during that year) is included within the § 1231 hodgepodge. Treas. Reg. § 1.1231-1(d) (1957). This may present a planning opportunity, since an election to report § 1231 gains on the installment method may allow § 1231 losses to exceed gains and thus to be treated as ordinary rather than capital losses.

¹¹⁰ INT. REV. CODE OF 1954, § 1232.

¹¹¹ INT. REV. CODE OF 1954, § 1240. This example is interesting because it reflects the conversion of compensatory payments (presumably not eligible for return under § 453) into a property-type transaction that may come within the statute. The reasons behind the enactment of § 1240 are explored in Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745, 747-49 (1955).

timber as a sale or exchange of such timber; therefore, the taxpayer must recognize gain equal to the difference between the basis of the timber and its fair market value at the time of cutting, whether or not there has been an actual sale. Because of the instant recognition provided by the statute, the installment method seems irrelevant.¹¹² Similarly, the transfer of a patent in a transaction qualifying under section 1235 and in which the consideration to be paid is contingent upon productivity appears not to be within section 453. Although section 1235 grants capital gain treatment, the transaction posed remains "open"; thus, the amount realized and the "selling price," for the purposes of section 453, are not known, and the taxpayer may recover his basis prior to recognition of gain.¹¹³

Certain transactions that fail to qualify as "sale or exchange" may still fall within the larger group described by the phrase "sale or other disposition." In such situations section 453 remains applicable. But where the transferor has not disposed of a sufficient interest in the asset, the transaction is not a "sale or other disposition" within section 1001(a). In this case the taxpayer will be denied the right to offset his property basis against the amounts received, and the installment method will be unavailable.

Congressional action to change capital gain into ordinary income (usually to prevent tax avoidance) should not affect the availability of the installment method any more than legislation changing ordinary income into capital gain. Thus, application of the installment method

¹¹² A further example is the conclusion that income generated by the disposition of an installment obligation is ineligible for return under § 453. Although the disposition transaction seems to qualify under § 453(b), § 453(d) compels immediate recognition of the deferred gain. Further deferral under § 453(b), therefore, seems to be at odds with the statutory machinery in § 453(d). See *Krist v. Commissioner*, 231 F.2d 548, 550 (9th Cir. 1956).

¹¹³ Of course, the Commissioner takes the position that "patent rights, dependent upon estimated prospective earnings or sales," together with other "contracts and claims to receive indefinite amounts of income," will be subject to valuation "except in rare and extraordinary cases," Rev. Rul. 58-402, 1958-2 CUM. BULL. 15, 17-18. If the Commissioner is successful in so valuing the transferor's right to receive payments, the installment method should become available. Amounts received in excess of the year-of-"sale" valuation on such rights presumably will be income to the transferor when received. The nature of amounts received in excess of the ascertained value, however, might be treated not as capital gain, but rather as ordinary income, since such payments would not be treated as part of the ersatz "sale or exchange." *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952), *aff'g* 17 T.C. 797 (1951). The transferring taxpayer may thus agree to a high valuation on the amount realized to protect himself against ordinary income treatment with respect to the potential profits from use of the patent. The taxpayer could then obtain his deferral via § 453 rather than the less even *Burnet v. Logan* route.

is not directly affected by sections 1245 and 1250, which were enacted to prevent taxpayers from obtaining depreciation deductions against ordinary income while the gain from the sale of the property was taxed at capital gain rates.¹¹⁴ Administrative embroidery,¹¹⁵ questioned by some,¹¹⁶ has the effect of first taxing the recaptured depreciation to the seller. Thus, the income portion of each installment, as determined in the normal manner under section 453, will be treated as ordinary income until the amount of the gain that is treated as ordinary income under section 1245 or section 1250 has been received by the selling taxpayer. Following recapture of the depreciation, the gain portion of each installment will be treated according to normal principles.

This obligatory compartmentalization of the capital gain and income portions of the realized gain constitutes a departure from the general theory of section 453. For example, if a business is sold, the nature of the gain generated is determined by the underlying assets of the business.¹¹⁷ Thus, the income portion of each installment will consist both of capital and ordinary income. Since the forced allocation of the regulation strikes at the heart of the concept of installment method reporting, its appropriateness is questionable.¹¹⁸

In another area, also the product of recent legislative activity, Congress provided for the potential conversion of what might have been capital gain into ordinary income. The imputed interest provision¹¹⁹ is designed to treat as interest a specific portion of the amount realized by the seller when the agreement between the parties makes no provision for interest.¹²⁰ Under prior law the mere failure to provide for interest in installment sales could result in the entire amount realized being treated as capital gain, even though there existed, due to the delayed payment aspect, a silent interest factor which, if designated as such, would have been ordinary income. The statutory remedy takes effect if no interest is specified or if that specified is too low, and

¹¹⁴ See Horowitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285 (1965).

¹¹⁵ Treas. Reg. § 1.1245-6(d) (1965); Proposed Treas. Reg. § 1.1250-1(b)(6), 31 Fed. Reg. 6968, 6971 (1966).

¹¹⁶ E.g., Branda, *Problems in Recapture of Depreciation*, N.Y.U. 23D INST. ON FED. TAX. 449, 478 (1965).

¹¹⁷ See *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945). See pp. 254-58 *infra*, for discussion relating to the use of the installment method in the sale of a business.

¹¹⁸ See Levy, *Installment Sales of Real Estate*, N.Y.U. 25TH INST. ON FED. TAX 29, 38-39 (1967).

¹¹⁹ INT. REV. CODE of 1954, § 483.

¹²⁰ S. REP. NO. 830, 88th Cong., 2d Sess. 101-04 (1964).

the statute treats a portion of each payment as interest. The portion thus treated cannot be considered as part of the sales price. The interest portion of the amount to be paid under the contract is, in effect, carved out and treated outside the provisions of section 453.¹²¹ Thus, since the so-called "unstated interest" is not considered part of the "selling price" or the "total contract price" as those terms are used in section 453, the income portion of each payment, and perhaps even the availability of section 453, are affected. Suppose, for example, that property is sold for \$20,000 (no interest being specified) with a down payment of thirty percent of the selling price, or \$6,000. The imputed interest provision takes hold, and the total unstated interest is shaved off the selling price. The transaction is thereby disqualified, the seller having received more than thirty percent of the selling price in the year of sale. When the imputed interest provision has potential application, it is hazardous to provide an initial payment that is close to the ceiling on eligible installment sales.

In one instance where ordinary income is transformed into capital gain, the installment method may limit the effect of the change. Section 1239 provides that gain recognized upon the transfer of depreciable property to a corporation shall be treated as productive of ordinary income if more than eighty percent of the stock of such corporation is owned by the transferor or those within his family group.¹²² An eligible installment transfer to the corporation¹²³ can be employed to soften the effect of section 1239 by preventing contemporaneous recognition of the full amount of the gain realized on the transfer. The depreciation deductions available to the corporation are at least available to offset the ordinary income generated to the transferor by receipt of the installment payments. This balance may be desirable if the payments are to be made over a period of time longer than that during which the depreciation deductions will be available to the corporation, or if the shareholder's tax rate is less than that of the corporation. To resolve any doubts about whether the transferring shareholder is benefiting via the depreciation deductions at the corporate level, one writer suggests that the corporation not pay its installment obligation.¹²⁴ The transferring shareholder receives no taxable income and the deprecia-

¹²¹ Treas. Reg. § 1.453-1(b)(2) (1966).

¹²² H. REP. NO. 586, 82d Cong., 1st Sess. 26, 120-21 (1951); S. REP. NO. 781, 82d Cong., 1st Sess. 69-70 (1951).

¹²³ It is unnecessary to classify the transaction as a "sale," since it is clearly a "disposition."

¹²⁴ Goldstein, *supra* note 83, at 57.

tion deductions of the corporation can be computed on its new "cost" basis. The difficulty with such an approach is obvious: the "sale" transaction to the controlled corporation is subject to attack as lacking substance. Thus, the transfer becomes a contribution to the corporation's capital, drastically reducing its depreciation deduction.¹²⁵ If any amounts are subsequently paid on the "notes," dividend income might well result.

This discussion points up an obvious truth. As with any transaction facing analysis under the Code, a sale potentially eligible under section 443 must actually be what it purports to be. On occasion taxpayers resort to the stratagem of an intermediate transaction, which they hope will be classified as a sale, in an effort to obtain the deferral offered by section 453. If the purchaser pays or desires to pay the entire purchase price in the year of sale, the selling taxpayer has at times been advised to effect an intermediate installment sale of the property to a corporation (newly formed for this specific purpose) and contemporaneously direct the purchaser to pay the consideration to the corporation.¹²⁶ The amounts so received by the corporation are then used to fund the installment payments to the transferor, who claims shelter under section 453. This unsophisticated attempt at tax avoidance has been slapped down, with the assistance of some of the "old chestnuts" of the lore of substance over form.¹²⁷

¹²⁵ The property will retain the transferor's basis in the hands of the corporation. INT. REV. CODE of 1954, § 362(a)(2). There may, however, be an upward adjustment to the basis of the transferor's stock equal to the basis of the transferred property. Treas. Reg. § 1.118-1 (1956); Edward Mallinckrodt, Jr., 38 B.T.A. 960, 969 (1938).

¹²⁶ See *Commissioner v. Griffiths*, 103 F.2d 110 (7th Cir.), *aff'd*, 308 U.S. 355 (1939); *Belle G. Loewenberg*, 39 B.T.A. 844 (1939).

¹²⁷ In *Commissioner v. Griffiths*, 103 F.2d 110 (7th Cir.), *aff'd* 308 U.S. 355 (1939), the taxpayer relied on *Gregory v. Helvering*, 293 U.S. 465 (1935), but the corporation was regarded by the court as having no business or corporate purpose; *accord*, *Belle G. Loewenberg*, 39 B.T.A. 844 (1939). In a fairly recent use of this same device, the Fifth Circuit, citing *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), concluded that the sale was made directly by the selling individual to the eventual purchaser, thus rendering § 453 inapplicable. *Hindes v. United States*, 326 F.2d 150 (5th Cir.), *cert. denied*, 337 U.S. 908 (1964), *rev'g on other grounds* 214 F. Supp. 583 (W.D. Tex. 1963). See also *Blueberry Land Co. v. Commissioner*, 361 F.2d 93 (5th Cir. 1966). On appeal from remand in *Hindes* the taxpayer found that defeat was double edged. The "sale" to the newly-formed corporation was at a price \$35,000 less than that paid by the eventual purchaser, presumably to allow retention of some amount by the corporation for the payment of a real estate commission and, perhaps, to make the transaction appear more realistic. The taxpayer was unable to recover, or receive credit for, the income tax paid by the corporation as a result of the "sale" by it to the eventual purchaser, even though it was found that the sale was made by the taxpayer in his individual capacity. The result was a partial double tax. *Hindes v. United States*, 371 F.2d 650 (5th Cir.), *cert. denied*, 386 U.S. 992 (1967).

IV

THE ELECTION—ITS BINDING NATURE—HOW MADE

Questions about what constitutes a proper election of the installment method have been at the storm center in the development of authority under section 453. A litigious Commissioner has questioned the use of the method many times, alleging that a timely or proper election of the method was not made. His success has not been startling; recently, he was compelled to reconsider his position on the question.¹²⁸

The Supreme Court early concluded that to allow a taxpayer to change from one elective method to another "would require recomputation and readjustment of tax liability for subsequent years and impose burdensome uncertainties upon the administration of the revenue laws."¹²⁹ The one settled principle in this confused area is that an election, once made, is binding upon the taxpayer. Of course, this statement has only a superficial simplicity, since it is often doubtful whether the taxpayer has in fact made any election, especially when he has made no decision that can be considered inconsistent with election of the installment method.

A. Effect of Subsequent Events

An initial problem has been whether the taxpayer can effectively adopt the installment method when the previously elected alternative turns out not to bring with it all that it had promised when chosen. Since this problem concerns the effect of subsequent events upon the binding nature of an election, it is different from cases in which the taxpayer attempts to alter his choice upon a showing that he did not know all the relevant facts at the time the selection was made.¹³⁰

When use of the first method chosen increases the tax impact

¹²⁸ The result of this reconsideration was Rev. Rul. 65-297, 1965-2 CUM. BULL. 152. Discussion here will be limited to elections under § 453(b), under which each sale constitutes a separate elective opportunity.

¹²⁹ *Pacific Nat'l Co. v. Welch*, 304 U.S. 191, 194 (1938).

¹³⁰ *E.g.*, *Lucas v. Sterling Oil & Gas Co.*, 62 F.2d 951 (6th Cir. 1933), involving an option other than the installment method. See Note, *The Election Concept in Tax Law*, 47 VA. L. REV. 72, 74 (1961). Many of the cases cited hereinafter are quite close to *Sterling Oil*, but the liberality of that decision has never affected the decisions under § 453, where a "hard-line" has been taken on the issue of change after an inconsistent election. There is some authority for allowing the taxpayer to effect a change when the circumstances existing at the time the election was made were such that it was not likely that an intelligent election could have been made (*e.g.*, very recent change of administrative position by Commissioner or change in statute). See *Morrow, Becker & Ewing, Inc. v. Commissioner*, 57 F.2d 1 (5th Cir. 1932) (involving the installment method).

beyond that expected, the taxpayer should not be allowed to change to what he views as a more beneficial method of reporting. Because of an error in the computation of basis, the taxpayer in *Sylvia S. Strauss*¹³¹ reported a gain of less than twenty dollars on the sale of real property. Soon after filing the return the taxpayer realized that she should have used the fair market value of the property at her husband's death as its basis. She thereupon filed an amended return reporting a substantially larger gain, and sought to elect the installment method. Even though the overestimation of the basis was "due to a mistaken knowledge of the law," the Board refused to permit the change.¹³² The same conclusion was reached when the taxpayer's mistake resulted from a complete unawareness of the availability or existence of the installment method.¹³³ In *Albert Vischia*,¹³⁴ reduction of the available net operating loss changed the taxpayer's reported net loss into a net gain. Even though the Commissioner's adjustments in other areas made the installment method a more reasonable choice, change was denied because "gain was reported and the transaction treated as closed."¹³⁵

In each of the above cases, the taxpayer had adopted a method plainly inconsistent with the one later sought. But the manner of income inclusion effected by the taxpayer does not always represent an inconsistent choice. For example, the inclusion in income of rental payments received as a result of a transaction that was subsequently determined to be a sale has been held not to prohibit the taxpayer from making a subsequent choice of the installment method.¹³⁶

The case is quite different, however, if the initial choice of the

¹³¹ 33 B.T.A. 855 (1935), *aff'd*, 87 F.2d 1018 (2d Cir. 1937).

¹³² *Id.* at 856.

¹³³ *Liberty Realty Corp.*, 26 B.T.A. 1119 (1932).

¹³⁴ 26 T.C. 1027 (1956).

¹³⁵ *Id.* at 1030. See also *Jacobs v. Commissioner*, 224 F.2d 412 (9th Cir. 1955). Some decisions in other areas distinguish between a mistake concerning the tax consequences and one based on ignorance of the law, being firm with respect to the former and more liberal in instances of the latter. *E.g.*, *Estate of Darby v. Wiseman*, 323 F.2d 792 (10th Cir. 1963); *Richardson v. Commissioner*, 126 F.2d 562, 569 (2d Cir. 1942) (supplemental opinion). This subtlety does not appear in the installment method cases. Also, the cases do not indicate whether the receipt of bad advice will constitute a basis for later change. *E.g.*, *C.H. Mead Coal Co. v. Commissioner*, 106 F.2d 388 (4th Cir. 1939). Control of this reason for change would be difficult; manifestly, many taxpayers who want to effect a change have received less than sage counsel.

¹³⁶ *Scales v. Commissioner*, 211 F.2d 133 (6th Cir. 1954). Thus, failure to make any choice is not considered an inconsistent choice. *E.g.*, *Paul H. Travis*, 47 T.C. 502, 514 (1967). Even though a prior choice is determined to be not inconsistent with later election of the installment method, the question still remains whether the taxpayer subsequently effects a proper election of that method. This separable issue will be dealt with at pp. 220-29 *infra*.

taxpayer is completely disallowed by the Commissioner rather than simply made less desirable by the proposal of adjustments that affect the prior choice. This seems to represent a different situation, because the taxpayer was not presented, at the time he made the election, with real alternatives; the one chosen was in actuality unavailable. In *Mamula v. Commissioner*,¹³⁷ the taxpayer chose to report the income from the sale of real property on the deferred payment basis.¹³⁸ As a result of this selection, no income from the sale was reported on the return for the year in which the sale was made. The taxpayer took the position that since the buyer's obligations had no fair market value, the cash payments received were to be first applied against basis.¹³⁹ An audit of the taxpayer's returns prompted the Commissioner to take the position that the deferred payment method was unavailable, since the buyer's obligations did have an ascertainable value. Upon notice of the Commissioner's position, the taxpayer conceded and requested that he be allowed to report the gain realized under section 453. The Tax Court upheld the Commissioner's denial of the installment method on the ground that the method initially chosen "was at least arguably open" to the taxpayer, who selected from alternatives that he thought were available.¹⁴⁰

The Court of Appeals disagreed. It reasoned that, since the choice of the deferred payment method was not allowable, it was not binding on the Commissioner. Mutuality therefore required that the taxpayer not be bound by the selection. The prior income calculations must be set aside and "of necessity"¹⁴¹ a new computation of income effected. In such situations, the fear that election change would impose a tremendous burden upon the revenue system by requiring recomputation is not applicable. The recomputation comes about not as a result of a change of method instituted by the taxpayer, but rather as a result of the Commissioner's disallowance of the method chosen.

One can conclude from *Mamula* that an election will preclude one from later choosing an alternative method of reporting only when

¹³⁷ 346 F.2d 1016 (9th Cir. 1965).

¹³⁸ Use of this basis is authorized administratively with respect to sales of real property by Treas. Reg. § 1.453-6 (1958). Judicial authorization exists with respect to personalty. *E.g.*, Mainard E. Crosby, 14 B.T.A. 980 (1929), *acquiesced in*, IX-1 CUM. BULL. 13 (1930).

¹³⁹ See Treas. Reg. § 1.453-6(a)(2) (1958). This feature constitutes the distinctive element of the deferred payment method, for if the buyer's obligations have a fair market value, a cash basis taxpayer must treat the obligations as part of the amount realized.

¹⁴⁰ Peter Mamula, 41 T.C. 572, 576 (1964).

¹⁴¹ 346 F.2d at 1019 (emphasis in original).

the initial opportunity to choose between the alternative methods was real. A more extreme factual situation than that presented in *Sylvia J. Strauss*¹⁴² would compel a different result than that reached by the Board. For example, suppose a taxpayer greatly overestimates his basis in the property sold and reports a loss from its disposition. The Commissioner, upon recomputation of the basis, concludes that the taxpayer realized a gain from the disposition. The taxpayer should not be barred from adopting the installment method with respect to the newly determined gain, because this is his first opportunity to choose a method of reporting the gain. From *Mamula* the conclusion is drawn that if the method chosen is not available, the selection process is colored and the taxpayer is to be allowed a second chance to pick from available options.

But it must be remembered that the *Mamula* decision would allow a subsequent change by the taxpayer only when the method chosen is *substantively* unavailable. Thus, if the method chosen becomes unavailable because the taxpayer's election is tardy, he gets no second chance at the selection process.¹⁴³ Other adjustments by the Commissioner may drastically alter the setting in which the taxpayer made his initial choice, but will not be grounds for change of election, if the originally selected method remains a substantively viable alternative. Thus, in *Samuel Pollack*¹⁴⁴ the denial of a corporation's Subchapter S status resulted in the disallowance of large corporate losses claimed on the taxpayer's individual return.¹⁴⁵ The taxpayer was not allowed to reconsider his previous selection of the closed contract method with respect to gain realized on the sale of real property. Distinguishing *Mamula*, the Tax Court noted that the taxpayer made an available election on his return, even though nightmarish consequences were made to follow from later adjustments made by the Commissioner.

Although the Tax Court at least displayed a willingness to follow the *Mamula* reasoning in *Pollack*, its decision in *George E. Freitas*¹⁴⁶ is contrary to the result in *Mamula*. The Tax Court found that the taxpayer could not use the deferred payment method, selected by him in a timely return, on the ground that the method is unavailable to an

¹⁴² 33 B.T.A. 855 (1935), *aff'd*, 87 F.2d 1018 (2d Cir. 1937).

¹⁴³ For example, if gain from the sale of property is not included in the original return, and the taxpayer files an amended return including the sale (and electing the installment method) beyond the time allowed by Rev. Rul. 65-297, 1965-2 CUM. BULL. 152, he should not be given another turn at the election process.

¹⁴⁴ 47 T.C. 92 (1966).

¹⁴⁵ INT. REV. CODE OF 1954, § 1374.

¹⁴⁶ 35 P-H Tax Ct. Mem. 611 (1966).

accrual basis taxpayer.¹⁴⁷ The taxpayer's attempt to adopt the installment method in the Tax Court was dismissed as untimely and regarded as ineffective because of the prior inconsistent election. Since the taxpayer's initial choice was substantively unavailable, the result in *Freitas* seems to conflict with that in *Mamula*,¹⁴⁸ to which no reference was made.

The notion of substantive unavailability apparently encompasses all corners of the administrative or legislative authorization of the initial election made by the taxpayer. While the concept may be of some use in other areas where the revenue laws afford an election, it may have only narrow application to the installment method election. Suppose, for example, the taxpayer initially elects the installment method, and later analysis renders it substantively unavailable because the taxpayer is shown to have received more than thirty percent of the selling price in the year of sale. Though *Mamula* apparently would allow the taxpayer a further opportunity to select from available alternatives, the circumstances are such that only one method remains viable: to return the gain realized in the year of sale on a closed-contract method. Theoretically, the taxpayer could then argue that the buyer's obligations had no fair market value and that therefore he is entitled to receive payments against his basis before reporting again. But he would probably have great difficulty showing that the obligations had no value, especially after having included them at face in his ill-fated attempt to adopt the installment method.¹⁴⁹

Related to the *Mamula* formulation is the idea that a taxpayer should not be held to his choice of the installment method if that method does not accurately reflect income. Arguably, since the Commissioner may impose an alternate method when he is convinced that the one selected does not accurately reflect income,¹⁵⁰ the taxpayer should not be bound by an election that has the same failing. In the slender authority on this question, however, it is difficult to discern when the installment method will be viewed as failing to reflect income.

¹⁴⁷ This principle was established in *George L. Castner Co.*, 30 T.C. 1061 (1958).

¹⁴⁸ Actually, the substantive unavailability was more complete in *Freitas* than in *Mamula*. Even though the buyer's obligation was found to have a fair market value in *Mamula*, the method authorized by Treas. Reg. § 1.453-6 (1958) was nonetheless available. Of course, it would not have been advantageous, since the taxpayer would have been required to treat the obligation as the equivalent of cash, thus causing gain to have been realized in the year of sale. But, since possible recovery of cost is the chief feature of the deferred payment method authorized by the regulations, the taxpayer in *Mamula* may be seen as having been substantively barred from using the method he sought.

¹⁴⁹ Cf. *Sterling v. Ham*, 3 F. Supp. 386 (D. Me. 1933).

¹⁵⁰ INT. REV. CODE of 1954, § 446(b).

In *Key Largo Shores Properties, Inc.*,¹⁵¹ the leading case on the issue, the taxpayer sold Florida land for cash, the assumption of a first mortgage, and the execution of a second mortgage. Prior to the end of the year in which the sale occurred, it became apparent that the purchaser was financially irresponsible (having defaulted on the first payment), that the second mortgage was valueless, and that no further payments would be made by the purchaser on the indebtedness. Concurrently, land values in Florida began a dizzy decline. Although the taxpayer's return for the year of sale included as income a large percentage of the year-of-sale payments pursuant to the installment method, the Board, citing the predecessor to section 446(b), indicated that a taxpayer should not be "irrevocably bound by the election of a method of reporting [income] when that method is erroneous."¹⁵²

In *Key Largo Shores*, adherence to the installment method would have required including as income in the year of sale almost the entire amount of the payments received during that period (because of the large profit "realized" on the sale), even though the taxpayer failed to recover his basis in the property and the value of the land declined so as to make it inadequate security for the purchaser's debt. The Board concluded that "[n]either administrative rules nor the forceful arguments in favor of administrative expediency can create income where in fact there is none."¹⁵³ This exception to the rule that an election, once made, is irrevocable apparently is limited to cases in which circumstances have occurred within the year of sale (or perhaps prior to the filing of the return for that year) which make it manifest that the installment method was an inappropriate vehicle to accurately reflect income.¹⁵⁴ If events subsequent to the year of sale cause the buyer to default, the taxpayer nonetheless remains tied to the installment method, any relief coming only from satisfaction of the buyer's obligation at less than face value.¹⁵⁵

B. *Manner of Election*

Although the statute indicates that use of the installment method is optional, it is completely silent concerning the manner of election. Since 1958 the regulations have provided that a taxpayer electing under section 453(b) "must set forth in his income tax return (or in a state-

¹⁵¹ 21 B.T.A. 1008 (1930).

¹⁵² *Id.* at 1012.

¹⁵³ *Id.* See also *Ives Dairy, Inc.*, 23 B.T.A. 579 (1931), *aff'd*, 65 F.2d 135 (5th Cir. 1933).

¹⁵⁴ See *Estate of E.P. Lamberth*, 31 T.C. 302 (1958); *Biscayne Bay Islands Co.*, 23 B.T.A. 731 (1931).

¹⁵⁵ *Lucille L. Morrison*, 12 T.C. 1178 (1949); *Morgan Rundel*, 21 B.T.A. 1019 (1930).

ment attached thereto) for the year of the sale or other disposition the computation of the gross profit on the sale or other disposition under the installment method.”¹⁵⁶ Prior to this provision, even the regulations had been silent on the manner of election. Early bravado induced the Commissioner to take the position that an election “must be exercised in a timely filed federal income tax return for the taxable year in which such sale was made.”¹⁵⁷ This position was only slightly mitigated by a recognition that the installment method could be used, via an amended return, when a taxpayer, originally claiming nonrecognition of a sale of a residence under section 1034, failed to meet the requirements of section 1034(a).¹⁵⁸ The Commissioner remained insistent that a taxpayer who filed a delinquent return could not elect the installment method,¹⁵⁹ even though the return was filed prior to his discovery that section 1034 nonrecognition would not be available.

This ruling displays the difficulty in applying a strict rule such as that contained in the Commissioner’s terse statement that an installment method election must be made on a timely return filed in the year of sale. Although the statute expressly grants to the Commissioner broad administrative authority in fixing the manner in which the statute is to function, neither the statute nor the regulations call for an election upon a timely return. Further, there are separately operating sanctions within the Code for negligence¹⁶⁰ and for delinquency in return filing.¹⁶¹ To deny the use of the installment method because of delinquency imposes an added penalty not contemplated in the statute. The Commissioner’s lack of success in obtaining judicial approval of his administrative position may be analyzed in terms of decisions falling within four categories.

1. *Election upon Delinquent Return*

The first category concerns situations in which the taxpayer fails to file a timely return, but seeks, through a delinquent return for the year of sale, to claim the installment method. In *C’de Baca v. Commissioner*,¹⁶² the court of appeals, reversing the Tax Court,¹⁶³ sounded the general theme for these cases. Neither the statute nor the regulations require that the taxpayer make the election upon a timely re-

¹⁵⁶ Treas. Reg. § 1.453-8(b)(1) (1958).

¹⁵⁷ Rev. Rul. 93, 1953-1 CUM. BULL. 82.

¹⁵⁸ Rev. Rul. 56-396, 1956-2 CUM. BULL. 298.

¹⁵⁹ *Id.* at 300.

¹⁶⁰ INT. REV. CODE of 1954, § 6653(a).

¹⁶¹ INT. REV. CODE of 1954, § 6651.

¹⁶² 326 F.2d 189 (5th Cir. 1964).

¹⁶³ *Marion C’de Baca*, 38 T.C. 609 (1962), *rev’d*, 326 F.2d 189 (5th Cir. 1964).

turn;¹⁶⁴ to deny the installment method to the late-filing taxpayer would be to impose a penalty. But the law does not casually inflict punishment, especially when there are separately operative and specifically devised sanctions within the statute. The fear expressed by some that the result reached would extend the filing period and encourage retrospective elections¹⁶⁵ seems to have been dispelled. Nor does it appear that the taxpayer must show good cause why the return was not filed to justify his subsequent election of the installment method upon a delinquent return. In *F.E. McGillick Co.*,¹⁶⁶ there were some grounds for arguing that there was good cause for the delinquency, since the taxpayer's president believed in good faith that the corporation was tax exempt. The Tax Court relied upon the sentiment expressed in *C'de Baca* that the potential applicability of the delinquency penalty made it unnecessary to consider the relevance of the reasons for the taxpayer's delinquency.

The Commissioner has specifically approved these cases and has announced that an election made on a delinquent return for the year of sale will be accepted.¹⁶⁷ Naturally, since a tax may be assessed at any time in situations where no return has been filed,¹⁶⁸ the ruling does not require the delinquent return to be filed within any specific time. But what if the years subsequent to the year of sale, for which returns were filed, are closed for assessment? Whereas the Commissioner could propose adjustments in the year of sale, he would be prevented from doing so in subsequent years in which the taxpayer had received payments related to the prior sale. The Commissioner has ruled that a delinquent return containing an installment method election will not be recognized as valid on the election question "if the assessment or collection of *any* portion of the tax for *any* taxable year resulting from the application of the installment method to such sale is prevented by the operation of the statute of limitations"¹⁶⁹

¹⁶⁴ Though the requirement that the return be timely existed in Rev. Rul. 93, 1953-1 CUM. BULL. 82, these opinions constitute acceptance of the view that a ruling is not to be accorded the weight of a regulation.

¹⁶⁵ 61 MICH. L. REV. 1189, 1192 (1963).

¹⁶⁶ 42 T.C. 1059 (1964).

¹⁶⁷ Rev. Rul. 65-297, 1965-2 CUM. BULL. 152. This ruling revoked Rev. Rul. 93, 1953-1 CUM. BULL. 82. It also modified Rev. Rul. 56-396, 1956-2 CUM. BULL. 298, "to eliminate the conclusion that such an election is not valid when made in an untimely filed return." The administrative concession renders obsolete the holdings in *Cedar Valley Distillery, Inc.*, 16 T.C. 870, 881-82 (1951), and *Sarah Briarly*, 29 B.T.A. 256 (1933).

¹⁶⁸ INT. REV. CODE of 1954, § 6501(c)(3).

¹⁶⁹ Rev. Rul. 65-297, 1965-2 CUM. BULL. 152, 153 (emphasis added). There is some authority for the Commissioner's position. *Howbert v. Norris*, 72 F.2d 753 (10th Cir. 1934).

Thus, if the taxpayer has not reported any of the installments received from the sale, a delinquent return electing the installment method must be filed while the Commissioner is still able to make assessments with respect to those years in which installment payments were received. For example, if the taxpayer received no payment in 1967, the year of sale, and received installment payments in each of the three subsequent years, which were not included as income on returns filed for those years (or, if included, not properly so), the installment method election would be valid only if the delinquent return for the year of sale were filed early enough to allow the Commissioner to make assessments with respect to 1968, 1969, and 1970. If, however, the selling taxpayer properly reported the installments received from 1968 through 1970, no tax would be due in those years with respect to the sale, and the taxpayer could make a valid installment method election in a delinquent return for 1967 filed at any time.

2. Omission of Sale from Timely Return

The second category includes situations in which the taxpayer has filed a timely return but has failed to make any mention of the sale, or to include any proceeds therefrom, and seeks to elect the installment method via an amended return for that year. Here again the Commissioner's litigation record has not been outstanding. In *Hornberger v. Commissioner*,¹⁷⁰ the taxpayer's accounting firm mistakenly failed to report any portion of a sale of realty. In allowing the installment method election on an amended return, the court of appeals not only referred to the penalties for negligence and fraud and the failure of the statute to require the kind of election required by the Commissioner, but also noted that the evidence showed the original omission was "honest error."¹⁷¹ In *Estate of Lipman*,¹⁷² the court excused an omission resulting from the oversight of an accountant, and, in *Stouffer v. United States*,¹⁷³ the court expressly concluded that the "failure to report was without any negligence"¹⁷⁴ on the part of the taxpayer.

This thread was picked up in the Commissioner's recent ruling wherein it is stated that an amended return filed for the year of sale, not barred by the statute of limitations, may be a proper vehicle for election of the installment method if, "in good faith, the taxpayer failed to exercise the installment method election . . . on a timely filed

¹⁷⁰ 289 F.2d 602 (5th Cir. 1961).

¹⁷¹ *Id.* at 604.

¹⁷² 245 F. Supp. 393 (E.D. Tenn. 1965), *aff'd*, 376 F.2d 455 (6th Cir. 1967).

¹⁷³ 225 F. Supp. 965 (S.D. Ohio 1962).

¹⁷⁴ *Id.* at 969.

original return for the year of sale"¹⁷⁵ To what extent is the Commissioner on sound ground in requiring that the failure to include the item in the original return be a "good-faith" omission? Aside from the troublesome semantic question involved—*e.g.*, if the taxpayer is negligent in failing to include the sale in the original return can he be said to be lacking in good faith?—there still remains the point, to which the judiciary has made allusion, that there are separately operating sanctions within the Code dealing with careless and intentional violations of the revenue laws. Thus, for example, if an audit by the Commissioner reveals the omission, the taxpayer should be able to file an amended return electing the installment method with respect to the omitted sale even if the Commissioner asserts the five-percent negligence penalty. While a showing of "due care" on the part of the taxpayer will overcome the penalty,¹⁷⁶ a finding of negligence should not have the radiative effect of denying to the taxpayer the use of the installment method. Perhaps the Commissioner would not so contend, being of the view that the taxpayer may still have "good faith" even though he was negligent in not including the item in his original return. This seems reasonable. But what if the item is excluded from the original return as a result of a fraudulent motive? The taxpayer then becomes subject to a penalty "equal to 50 percent of the underpayment."¹⁷⁷ The Commissioner apparently would take the position that the failure to claim the installment method election on the original return was not the result of good faith, and therefore would deny the taxpayer the right to claim its benefit on an amended return.

It is true that some of the cases in which the taxpayer was allowed to claim the method via an amended return referred to the "excusable" failure of the taxpayer to effect the proper inclusion in the original return. By far the most significant theme of these cases, however, is the notion that Congress has provided separately operating penalties for these malefactions and to add a sanction that denies to the taxpayer a right to report income in a manner otherwise available would expand the penalty in a manner not contemplated. It seems, therefore, that the Commissioner may be in a tenuous position by requiring that "good faith" be a prerequisite to proper election of the installment method via an amended return. Of course, if the taxpayer is allowed to use the installment method, the underpayment, and thus the fraud penalty, will be reduced. This is not shocking; the underpayment for

¹⁷⁵ Rev. Rul. 65-297, 1965-2 CUM. BULL. 152.

¹⁷⁶ H. BALTER, TAX FRAUD AND EVASION § 8.2-3 (3d ed. 1963).

¹⁷⁷ INT. REV. CODE OF 1954, § 6653(b).

the purpose of determining the penalty should be computed in the same manner, and with the same entitlements, as though the taxpayer had filed a proper return. To compute income any differently, as would be the case if the installment method were denied, would be to expand the penalty in a manner apparently not considered by Congress. The taxpayer should be entitled to use the installment method when the omission of the sale was not fraudulent, even though other evidence of fraud justifies imposition of a penalty on the entire underpayment. But even when the taxpayer's fraud concerned the installment sale itself, no real justification exists for denying use of the installment method on an amended return. In all cases, the penalty operates independently, and it should not be made larger simply because the omitted item was a sale potentially eligible for return under section 453.

The same reasoning seems to apply to situations in which the taxpayer intentionally fails to file a return. There are penalties specifically designed to meet this abuse, and denial of an otherwise available accounting method is not one of them. One may argue, of course, that the Commissioner has broad rule-making powers and that in regulations, which he has indicated will be forthcoming,¹⁷⁸ he can properly take the position that a taxpayer subject to the fifty percent fraud penalty cannot utilize the installment method. If he takes this position, however, he will remain subject to "the attack that it [is] unauthorized as adding limitations beyond that authorized in the statute itself."¹⁷⁹

The requirement that the election must be made on an amended return filed for the year of sale "not barred by the statute of limitations"¹⁸⁰ seems entirely within the Commissioner's authority. Acceptance or rejection of amended returns is properly a matter of discretion. It is natural for the Commissioner to require that the return be filed within a period during which an assessment can be made. One can only assume, however, that the period of limitations referred to includes that limitation made applicable by the circumstances. Thus, if the period of limitation is six years, as the result of a twenty-five percent understatement,¹⁸¹ or the circumstances are such that an assessment may be made at any time,¹⁸² the taxpayer seemingly may submit an amended return bearing an installment method election at any time within the "open" period. Here again, however, the ruling adds that

178 See Rev. Rul. 65-297, 1965-2 CUM. BULL. 152, 153.

179 *C'de Baca v. Commissioner*, 326 F.2d 189, 190 n.2 (5th Cir. 1964).

180 Rev. Rul. 65-297, 1965-2 CUM. BULL. 152.

181 INT. REV. CODE of 1954, § 6501(e)(1)(A).

182 *E.g.*, in the case of a false return. INT. REV. CODE of 1954, § 6501(c)(1).

the Commissioner must not be prevented, by reason of the statute of limitations, from collecting any of the tax generated by the receipt of payments subsequent to the year of sale.

3. *Transaction Erroneously Reflected on Original Return*

Related to the categories referred to above is the third type of situation in which the sale or its proceeds were included in a timely filed original return in a manner consistent with the subsequent election of the installment method but not reflecting the true nature of the transaction. These situations present a strong case for allowing the taxpayer to elect the installment method through an amended return; after losing several decisions,¹⁸³ the Commissioner announced that he would permit such an election.¹⁸⁴

Although the ruling speaks only of an amended return as the proper vehicle for making a subsequent installment method election, the Commissioner has been forced on several occasions to accept an election made in a different manner. In one situation the Commissioner held that, when a revenue agent had determined upon examination that a taxpayer was not entitled to the nonrecognition claimed pursuant to section 1034 (sale of residence) on his timely return, the taxpayer could obtain the benefit of the installment method if he filed a written statement with the Commissioner stating his nonqualification under section 1034 and accompanied the statement with an amended return for the year of sale.¹⁸⁵ But suppose the taxpayer wished to litigate the section 1034 question? Surely this should not prejudice his right to use the installment method with respect to any gain that is held to have been recognized as a result of the failure to obtain complete nonrecognition under section 1034. Alternative positions in pleading have long been a hallmark of modern practice. Thus, in *John F. Bayley*,¹⁸⁶ the Tax Court had little difficulty concluding that an amended petition in that proceeding was a proper elective vehicle in the event that the taxpayer lost on the nonrecognition question.¹⁸⁷

¹⁸³ *Glidden Co. v. United States*, 241 F. Supp. 195 (N.D. Ohio 1964) (transaction originally reported as a lease, but held taxable as a sale as claimed on amended return); *John P. Reaver*, 42 T.C. 72 (1964) (amounts received in year of sale originally treated as gross business receipts, but held taxable as long-term capital gain as claimed on amended return). See also *Scales v. Commissioner*, 211 F.2d 133 (6th Cir. 1954). Before the subsequent installment election is allowed it must be shown, as it was in these cases, that the prior inclusion was not inconsistent with a later choice of the installment method.

¹⁸⁴ Rev. Rul. 65-297, 1965-2 CUM. BULL. 152.

¹⁸⁵ See Rev. Rul. 56-396, 1956-2 CUM. BULL. 298.

¹⁸⁶ 35 T.C. 288 (1960).

¹⁸⁷ The Commissioner's acquiescence in *Bayley* and his apparent acceptance of the

The subsequent elective opportunity, however, should be exercised when the taxpayer is first presented with the opportunity to choose the installment method. In *Bayley* this moment came when the nonrecognition claimed on the original return was challenged before the Tax Court. The taxpayer would have difficulty claiming the installment method by an amended return submitted after failing to prevail on the nonrecognition issue before the Tax Court. Since the year would no longer be "open," the Commissioner probably would not accept the election. If a taxpayer wishes to litigate his dispute with the government in a forum other than the Tax Court, the first elective opportunity presumably occurs when the taxpayer files a claim for refund after the payment of a deficiency assessment.¹⁸⁸

4. *Election Made in the Year, Subsequent to Sale, When the First Payment Is Received*

The last category concerns situations in which the selling taxpayer receives no payment (other than evidences of indebtedness) in the year of sale, makes no reference to the sale in the return filed for the year of sale, and elects the installment method in a subsequent year when he receives his first payment. The Commissioner, hewing to his hard line that the election must be made on a timely return filed for the year of sale, has lost two cases on the issue. In *Jack Farber*,¹⁸⁹ the court noted that the present regulations—requiring that a taxpayer electing the installment method show the computation of gross profit from such sale in the return for the year of sale—applied only to years ending after December 17, 1958, and that the applicable administrative matter (the case involved the year 1952) was silent on the time and manner of election. Noting that the taxpayer's silence in the year of sale in no way constituted an inconsistent choice and that he received no part of the selling price in that year, the court concluded that "there was no occasion for reporting any amount of taxable income" in the year of sale. Thus, a timely election was made "when payments were received."¹⁹⁰ Essentially the same result was reached in *Nathan G. Spivey*.¹⁹¹ Although new regulations are promised, the Commissioner

view that the installment method can be claimed before the Tax Court with respect to an omitted sale renders obsolete the holdings in *W.A. Ireland*, 32 T.C. 994 (1959), *John W. Commons*, 20 T.C. 900 (1953), and *W.T. Thrift, Sr.*, 15 T.C. 366 (1950).

¹⁸⁸ In *Jolley v. United States*, 246 F. Supp. 533 (D. Nev. 1965), such an election was held proper.

¹⁸⁹ 26 T.C. 1142 (1961), *aff'd*, 312 F.2d 729 (2d Cir.), *cert. denied*, 374 U.S. 828 (1963).

¹⁹⁰ *Id.* at 1153.

¹⁹¹ 40 T.C. 1051 (1963).

has clearly indicated that he will follow *Farber* and *Spivey* only for years ending before December 18, 1958, and that for subsequent years the election must be made on the return for the year of sale, even though no payment is received during that year.¹⁹²

Although some commentators criticize the requirement that the election must be made in the year of sale even though no taxable payment is received in that year,¹⁹³ the Commissioner's view seems sound. If the taxpayer does not decide to utilize the installment method when he files the return for the year of sale, he will be obliged to report the realized gain in that return in accordance with accepted cash receipts or accrual principles, even though no payments other than evidences of indebtedness have been received. Since the failure to include any amount in income as a result of either of these methods indicates the taxpayer's decision to employ the installment method, it is reasonable to ask that he declare this decision on the return for the year of sale, be it a timely, delinquent, or amended return. Also, failure to include any amount in income with respect to a sale completed in the year is just as consistent with a decision by the taxpayer to recover his cost prior to reporting gain; thus, because of the varying tax treatment, it is reasonable to compel the taxpayer to make the decision in the return for the year of sale concerning how the income realized is to be reported. To hold otherwise would be to allow taxpayers not receiving any payment other than evidences of indebtedness in the year of sale a longer time in which to reach a decision on this question, which could unfairly work to their advantage.

The only case on this issue in which the 1958 regulations applied was decided in favor of the Commissioner. In *Ackerman v. United States*,¹⁹⁴ the taxpayer sold real property in the closing days of 1958 and realized a gain, although she received no payment in that year other than an evidence of indebtedness. The first payment was made January 2, 1959, and the taxpayer elected the installment method in the return filed for that year. The court of appeals easily concluded that the present regulations require an election in the year of sale and that

¹⁹² Rev. Rul. 65-297, 1965-2 CUM. BULL. 152. It has been argued that the present regulations do not clearly require that an express election be made on the return for the year of sale, and that the taxpayer is only required to show the computation of gross profit on the sale under the installment method. Hewitt, *Installment Method Election or Lack Thereof*, 48 A.B.A.J. 582, 584 (1962). The computation requirement, however, serves well enough to show the taxpayer's choice.

¹⁹³ Hewitt, *supra* note 192, at 585; Note, *The Election Concept in Tax Law*, 47 VA. L. REV. 72, 85-86 (1961).

¹⁹⁴ 318 F.2d 402 (10th Cir. 1963).

the requirement is "reasonable, clear in its terms, within the power of the Commissioner to promulgate and consistent with the statute."¹⁹⁵ Although the forthcoming regulations might state the rule more clearly, this result seems proper. The taxpayer should have to declare how the gain will be reported. The problems then focus upon the year of sale. Has the taxpayer made a prior inconsistent election for that year? If not, can he submit a delinquent or amended return for that year containing a valid election?

C. Identification of the Year of Sale—Electing Party

In certain situations, obviously, identification of the year of sale will become significant. This is a multi-faceted problem which can only be touched upon here. The dilemma is also relevant in applying the ceiling on initial payments, because the statute provides that payments "in the taxable year of sale" shall not "exceed 30 percent of the selling price."¹⁹⁶ Statements relating to when a sale takes place are understandably general.¹⁹⁷ When both parties become bound by the agreement, one to buy and the other to sell, the time of sale is usually fixed. A straight option situation, in which the seller receives an amount under an agreement giving the optionee the right to purchase the seller's property during a period of time, seems fairly clear. The amount received by the optionor hangs in suspension, in seeming violation of claim-of-right principles, until the option is exercised, in which case it is treated as part of the amount realized (capital gain or ordinary income, as the case may be), or until the option lapses, in which event the previously paid option price becomes ordinary income to the optionor.¹⁹⁸ Obviously, in the case of an option lapse, the option price becomes income to the "seller" at the time of the lapse and is not subject to deferral. When the option is exercised, however, the time of sale is fixed, and election of section 453 must be made in that taxable year. The previously paid option price is considered a year-of-sale payment, and may presumably create difficulties with regard to the ceiling on year-of-sale payments.

Some clear thinking has been done about the problem of contingent lease-or-purchase arrangements. In *Kitchin v. Commissioner*,¹⁹⁹

¹⁹⁵ *Id.* at 404.

¹⁹⁶ INT. REV. CODE of 1954, § 453(b)(2)(A) (emphasis added).

¹⁹⁷ See Chapman, *Time of Sale Under the Internal Revenue Code*, N.Y.U. 22d INST. ON FED. TAX. 139 (1964).

¹⁹⁸ *Commissioner v. Dill Co.*, 294 F.2d 291 (3d Cir. 1961).

¹⁹⁹ 340 F.2d 895, *rev'd on rehearing*, 353 F.2d 13 (4th Cir. 1965). For a discussion of the case and the issues involved, see Note, *Federal Income Tax Treatment of Equipment Lease-or-Purchase Agreements*, 52 VA. L. REV. 1336 (1966).

the court of appeals, on rehearing, withdrew its previous position that the amounts paid by the "purchaser" during the period prior to the decision to purchase were to be treated by the seller as in a straight option situation, *i.e.*, not income until the nature of the transaction becomes clear. The court concluded that the amounts received constitute rental income to the seller unless and until the right to purchase is exercised.

While adoption of the "lease-until-purchase" treatment in preference to the "wait-and-see" approach, which marks the usual option situation, bears largely upon the type of income generated to the "seller," the distinction is also relevant under section 453. The "sale" would not take place until the right to purchase is exercised, and it is on the return for that period that the election should be made. Unlike the straight option situation, the selling taxpayer in a "lease-until-purchase" situation would be less likely to run afoul of the thirty percent ceiling on year-of-sale payments, since the prior amounts paid would have been treated as rental income to the seller and thus should not be considered as part of the "selling price."

In light of the above discussion and the 1958 regulations, the decision in *Nunn v. Gray*²⁰⁰ seems wrong. In November 1952, the taxpayer sold real property for \$124,800, the purchaser executing a non-negotiable promissory note for the full payment. The note provided that the purchaser could reconvey the land to seller at any time and thereby cancel the indebtedness. The seller received no payment on the note in the year of sale, but did receive ten dollars, which the court describes as "an earnest payment since it was in addition to the agreed sales price."²⁰¹ The taxpayer did not refer to the sale in his return for 1952, but in the return for the following year, during which he received a sizable payment on the note, he adopted the installment method. In denying the Commissioner's contention that the taxpayer had not made a timely election, the court simply noted that 1953 was the year in which the seller "first received a substantial payment on a sale that was conditioned so the purchaser could have been relieved of his bargain at any time."²⁰² Obviously, the earnest money or deposit paid upon the execution of the deed should have been considered part of the selling price, even though it was additional to the consideration agreed upon in the note. That it was a very small amount is not important. As a deposit or earnest money, the amount became income to

²⁰⁰ 196 F. Supp. 305 (D. Ky. 1961).

²⁰¹ *Id.* at 306.

²⁰² *Id.* at 307.

the seller, as part of the amount realized, upon completion of the sale. This occurred in 1952, even though the terms of the note permitted the purchaser to be relieved of his obligation. Because of the need for an annual accounting of income, sales are deemed completed even though subject to possible contingencies. As the Tax Court has stated, "[t]here is nothing inharmonious between the conception of an absolute or completed sale and an agreement to repurchase later at the option of the purchaser."²⁰³ Thus, the sale should have been regarded as complete in 1952, and according to the present regulations, the taxpayer would have been required to make the election in the return for that year.

Identifying the party who has the burden to elect should create few problems. The regulations provide that the obligation falls upon the "taxpayer who sells or otherwise disposes" of the property.²⁰⁴ Although a partnership is not a taxpaying entity, it does file a return that has tax consequences for the partners. Thus, when the partnership is the selling entity and it fails to elect the installment method, the partners cannot claim its benefit.²⁰⁵

Presumably, some problems could develop concerning the identity of the selling party where, pursuant to local law, title to real property passes directly but is nonetheless subject to administration. Just as an estate in such situations is deemed the new shareholder for the purposes of determining who must consent when the property involved is Subchapter S stock,²⁰⁶ the estate should be regarded as the proper party to elect the installment method when the property is sold.²⁰⁷

V

THE CEILING ON PAYMENTS IN THE YEAR OF SALE

Similar to a proper election, the requirement of section 453(b)(2) (A) that the taxpayer receive not more than thirty percent of the selling price in the taxable year of sale is a threshold requirement for qualifica-

²⁰³ Metropolitan Commercial Corp., 32 P-H Tax Ct. Mem. 602, 610 (1963). See also William M. Davey, 30 B.T.A. 837 (1934).

²⁰⁴ Treas. Reg. § 1.453-8(b)(1) (1958).

²⁰⁵ John G. Scherf, Jr., 20 T.C. 346 (1953); George Rothenberg, P-H TAX CT. REP. & MEM. DEC. ¶ 48.38 (1967). See Wolfman, *Level for Determining Character of Partnership Income—"Entity v. Conduit" Principle in Partnership Taxation*, N.Y.U. 19TH INST. ON FED. TAX. 287, 295-96 (1961) (urging the conduit principle of election by the individual partners).

²⁰⁶ Rev. Rul. 62-116, 1962-2 CUM. BULL. 207.

²⁰⁷ This rule, of course, allows the fiduciary to elect the installment method when, because of other recognized losses, one or more beneficiaries prefer to realize the income within the year of sale. Cf. *Marcello v. Commissioner*, 380 F.2d 499, 508 (5th Cir. 1967).

tion. The statute provides, of course, that evidences of indebtedness of the purchaser shall not be deemed a payment in the year of sale. The goal of the thirty percent requirement is to assure that a contract is of an installment nature. But the requirement possesses a deceptive simplicity and has generated many problems.

The central questions are whether a given transfer is a payment within the statute and, if so, when it was made. Of course, implicit in the process is the determination of the "selling price" of the property, the measuring rod against which "payments" are set.

Obviously, cash and the fair market value of other property received by the taxpayer in the taxable year of sale must be viewed as payments within the thirty percent rule²⁰⁸ and as part of the selling price.

²⁰⁸ The same valuation of property (fair market value at time of sale) that is utilized in determining the amount realized should similarly be used in determining the amount of "payment." *E.g.*, Charles W. Yeager, 28 P-H Tax Ct. Mem. 169 (1959). Note that, if the Commissioner places a higher value on the property received than the seller, the added value will not "wash" itself out in a computation of the 30% requirement. For example, if the seller values the tangible property received at \$30 and the total consideration to be received at \$100, the sale would qualify under § 453. If, however, the Commissioner values the property at \$35, the selling price would be raised to \$105, and the sale would not qualify.

An apparent distinction exists with regard to valuation of rights to receive money. In *Tombari v. Commissioner*, 299 F.2d 889 (9th Cir. 1962), the taxpayer sold a pharmacy and received, as part of the consideration in the year of sale, a contract right to receive roughly \$75,000 that the purchasers possessed as a result of their prior sale of other property to a third party. In computing his eligibility to return the profit under § 453, the seller valued the contract right received at face value (\$75,000) with respect to the selling price, thereby ballooning that figure, and the year-of-sale payment was included at the agreed fair market value (\$50,000). In rejecting this strategem the court viewed the 30% rule as a measuring rod to be applied in the year of sale to determine whether the taxpayer would sustain a hardship if the realized gain were taxed fully in that year. Valuation of the indebtedness of third persons must be made on the basis of fair market value, since it offers the most realistic test of whether the taxpayer is entitled to use the relief authorized by § 453. Consequently, the court in *Tombari* held that the taxpayer was unable to use the installment method, because a determination of the selling price involves the "best possible evaluation of the consideration at the time of the sale" and this must be based upon the fair market value of the third party obligation.

Although the purchaser's own obligations are clearly excluded from consideration as payments in the year of sale, they must be used in determining the "selling price," the gross profit, and the total contract price. The problem is whether the obligations of the seller can be valued at less than face in making these determinations. In computing the amount realized under § 1001, the note may be valued by a cash basis taxpayer at less than face. Once the shift to § 453 is made, however, cash and accrual taxpayers are treated identically, and the obligations of the purchaser are considered at face value. This result is essential to an initial determination of the income to be included by the seller over the life of the pay-out. This accounts for the use of a term other than "amount realized" when the regulations state that "gross profit means the selling price less the adjusted basis as defined in section 1011" *Treas. Reg. § 1.453-1(b)(1)*, T.D. 6873, 1966-1 CUM. BULL. 101. Inclusion of the face amount of the purchaser's indebtedness in "the sell-

Concepts of income, historically relevant in determining whether the taxpayer has gross income within section 61, may be useful in determining the selling price. The "selling price" has been defined as the gross amount of the purchaser's obligation, and this includes amounts that are not paid directly to the seller but rather constitute income accessions includible within section 61.²⁰⁹ For example, if a prior indebtedness to the purchaser is cancelled in the year of sale as part of the bargain, the amount of such indebtedness is considered a "payment" and part of the selling price.²¹⁰

ing price" will, of course, cause that amount to be reflected in the gross profit, thus setting the quantum of income that is to be included over the period of the contract. This result is confirmed by the statute, which refers to "gross profit, realized or to be realized when payment is completed" INT. REV. CODE of 1954, § 453(a)(1); see J.W. McWilliams, 15 B.T.A. 329, 343 (1929).

²⁰⁹ See J.W. McWilliams, 15 B.T.A. 329, 342-43 (1929).

²¹⁰ W.H. Batcheller, 19 B.T.A. 1050, 1053-54 (1930); I.T. 2351, VI-1 CUM. BULL. 43 (1927) (extinguishment of mortgage indebtedness by purchaser-mortgagee). The amount of the cancelled indebtedness can properly be considered a payment for the application of the 30% rule even though the seller is not directly given amounts with which to pay the tax liability. "[B]eing relieved of a personal liability . . . the seller's other personal funds . . . are freed to be used in paying the tax." Ivan Irwin, Jr., 45 T.C. 544, 550 (1966). What effect would an election under § 108 to exclude cancellation of indebtedness income have upon income determination and qualification under § 453? "[I]t is not necessary for the income to be attributable to the discharge of the indebtedness itself in order to be eligible for the elective exclusion under section 108(a), but may arise from a discharge effected in consideration for the transfer of property . . ." Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 276 (1959). Suppose a taxpayer sells property for \$100,000 (basis \$10,000) for the cancellation of a \$50,000 indebtedness and the execution of a note in the amounts of \$50,000, calling for 5 annual payments of \$10,000, one of which was paid in the year of sale. Giving § 108(a) effect in a transaction possibly involving § 453 would be to treat the taxpayer as having received \$10,000 in the year of sale, of which \$8,000 would be treated as includible in income ($\$10,000 \times \$40,000 \div \$50,000$). This solution severs the cancellation of indebtedness income (for which the taxpayer has paid through a downward basis adjustment in retained property under § 1017) from the sale transaction in determining its eligibility and treatment under § 453.

What constitutes a cancellation of indebtedness sufficient to give rise to income can still be pivotal. See *Riss v. Commissioner*, 368 F.2d 965 (10th Cir. 1966), where the selling taxpayer had been a partner in a partnership whose assets and liabilities had been previously transferred to a corporation in which he held stock. The corporation listed a portion of the partnership deficit allocable to the seller as a receivable, which was subsequently cancelled upon the redemption of the taxpayer's stock. Despite the taxpayer's continuing pro rata responsibility to the partnership creditors for the obligations creating the partnership deficit, the court found the cancellation of the outstanding receivable constituted receipt of a payment sufficient to disqualify the redemption transfer from return under § 453. The seller was charged with the cancellation income even though the indebtedness prompting the corporate receivable remained very much alive as "residual contingent personal liability." *Id.* at 969. Although this result is questionable, it reveals the distinction between a cancellation, which the court found with respect to

A. *When the Buyer Assumes or Takes Subject to a Mortgage*

When a vendee assumes a mortgage on the property or takes it subject to a mortgage, is the amount of the mortgage indebtedness to be considered a "payment" and as part of the "selling price?" Taking the latter first, if we view the selling price as akin to the amount realized, the principle enunciated in *Crane v. Commissioner*²¹¹ would clearly include the mortgage indebtedness in that figure. This thought is picked up by the Commissioner's regulations, which state that the amount of the mortgage shall be included in the selling price.²¹²

The Commissioner's regulations have long provided that the amount of the mortgage shall not be considered part of the initial payment or the "total contract price"²¹³ to the extent it does not exceed the vendor's basis in the property sold. This approach seems reasonable, since the seller's liability for the indebtedness remains and thus is not actually received as a payment. Even with regard to payments made by the purchaser upon the mortgage indebtedness during the taxable year of sale, the Commissioner's regulations provide that the purchaser has not received a payment for purposes of section 453. These regulations were challenged and upheld in *Burnet v. S. & L. Building Corp.*²¹⁴ The Supreme Court faced two questions: (1) whether the amounts paid by the purchaser on the mortgage assumed by him should be considered payments to the vendor, and (2) whether the amount of the indebtedness assumed by the purchaser should be included in the total contract price. This seemingly two part problem is actually only

the corporate-shareholder indebtedness, and an assumption and payment, which it did not find with respect to the partnership liabilities.

²¹¹ 331 U.S. 1 (1947).

²¹² Treas. Reg. § 1.453-4(c) (1958). This selling price figure has the twofold relevance of constituting both the measuring rod against which year-of-sale payments are applied for the purpose of determining compliance with the 30% rule and the minuend for determining gross profit. Treas. Reg. § 1.453-1(b)(1), T.D. 6873, 1966-1 CUM. BULL. 101.

²¹³ Treas. Reg. § 1.453-4(c) (1958). The original provision (Treas. Reg. 69, art. 44 (1926)), was amended in 1929 to add the provision calling for "payment" treatment if the mortgage exceeds the vendor's basis. T.D. 4255, VIII-1 CUM. BULL. 165 (1929). No distinction is made between a first or second mortgage indebtedness. *Denco Lumber Co.*, 39 T.C. 8 (1962). If a mortgage is placed upon the property in the year of sale by the vendee (or even by the vendor, if it is keyed into the sale) and the proceeds of the mortgage are received by the seller, the amounts so received must be considered as payments within the year of sale. *Shubin v. Commissioner*, 67 F.2d 199 (3d Cir. 1933), *cert. denied*, 291 U.S. 664 (1934); *Stella H. McConnell*, 29 B.T.A. 32 (1933). This forces the triumph of form, since the seller may encumber his property prior to, and independent of, the sale, with the result that the assumption of the mortgage will not be considered as a payment (even though the mortgage loan was effected in the year of sale) except to the extent such loan exceeds basis.

²¹⁴ 288 U.S. 406 (1933).

one dilemma, for if an amount is to be considered a "payment" in the year of sale it should be considered part of the total contract price, lest an aberration be worked.

The issues in *S. & L. Building* can be illustrated by the following example. Suppose a taxpayer sells real property with a basis of \$500,000 for \$1,000,000, thus yielding a realized gain of \$500,000. The selling price consists of \$100,000 payable in the year of sale, a note executed by the seller and secured by a mortgage on the property in the amount of \$700,000, and the assumption of a \$200,000 mortgage which calls for the payment of \$20,000 annually. Suppose further that the purchaser makes a \$20,000 payment on the assumed mortgage in the year of sale. According to the government's position in *S. & L. Building*, the taxpayer should include \$62,500 in income in the year of sale ($\$100,000 \times \$500,000 \div \$800,000$). Seeing a tax benefit flowing from a greater deferral, the taxpayer argued that only \$60,000 ($\$120,000 \times \$500,000 \div \$1,000,000$) should be included in income for that year. He argued that the amounts paid on the assumed indebtedness should be treated as year-of-sale payments and that the entire amount of the indebtedness should be treated as part of the "total contract price."

Both positions, of course, reach the same result with respect to the total amount to be included in income. The difference is that the Commissioner's position would tax the income to the seller over a shorter period of time, *i.e.*, that period during which the seller actually receives direct payments. The taxpayer's position would spread the income over a longer period of time, and thus, because of the progressivity in the rate structure, would result in a lesser net tax liability on the entire transaction.²¹⁵ In reversing the court of appeals,²¹⁶ the Supreme Court noted the circumstances surrounding the origin of the statute and saw an apparent Congressional intent to allow a selling taxpayer to defer the income realized over the period of time during which he received payments. Accepting the taxpayer's position would allow situations that encourage postponement of collection of the income tax due from the sale "far beyond the time when the vendor would receive any direct payments."²¹⁷ Such deferral is not essential to satisfaction of the Congressional goal. The Court concluded that since the Commissioner's regula-

²¹⁵ Inclusion of the assumed mortgage indebtedness in the "selling price" (which is clear and accepted) leaves the gross profit figure fixed. Thus, a lower contract price means a larger portion of each installment is treated as income; the deferral span is thereby shortened.

²¹⁶ *S. & L. Bldg. Corp. v. Commissioner*, 60 F.2d 719 (2d Cir. 1932), *rev'd*, 288 U.S. 406 (1933).

²¹⁷ 288 U.S. at 414.

tions were "not contrary to any positive provision of the statute,"²¹⁸ it was an authorized exercise of administrative power.

In *S. & L. Building* the Court also approved the requirement of the regulation that the amount by which the assumed mortgage exceeds the seller's basis in the property is to be treated as a year-of-sale payment and included in the "total contract price." Thus, to modify the facts of the above example, assume that the taxpayer sells the property for \$100,000 payable in the year of sale, a \$300,000 note executed by the purchaser, and the assumption of a \$600,000 mortgage to which the property is subject. Since the taxpayer's basis was \$500,000, the regulation would tax \$200,000 to the taxpayer in the year of sale ($\$200,000 \times \$500,000 \div \$500,000$). Inclusion of the excess of the assumed mortgage over the seller's basis as a payment in the year of sale charges the seller with the entire amount of the excess over basis in that year. Referring to the problem of assumed mortgages, the Supreme Court noted that real estate dispositions in which the property is encumbered by liens "give rise to many complications which Congress could not readily foresee."²¹⁹ Congress therefore entrusted "to the Commissioner wide discretion in respect to details."²²⁰ Since "[n]o positive provision in the statute required that [the excess of the assumed mortgage over basis] . . . be spread over subsequent years,"²²¹ the regulation "followed the general purpose to place reasonable limitation upon the spread of the tax."²²²

The regulation is markedly similar to section 357(c) of the Code, which treats liabilities in excess of basis assumed by the transferee corporation as gain taxed to the transferor in the year in which the transaction occurs. In the problem posed the regulation taxes the seller in the year of sale for the economic gain he receives on account of the mortgage indebtedness he incurred, *i.e.*, the receipt of \$600,000 borrowed on an investment of \$500,000, but which was not taxed to him at that time because it gave rise to an off-setting indebtedness in that amount.

Because including the excess of an assumed mortgage over basis as a year-of-sale payment raised possible problems with qualification under the thirty percent rule, taxpayers naturally began to provide in the agreement of sale that the assumption of the mortgage by the purchaser would not be effected until a specific time after the year of sale.²²³

²¹⁸ *Id.* at 415.

²¹⁹ *Id.* at 414.

²²⁰ *Id.*

²²¹ *Id.* at 415.

²²² *Id.* at 414.

²²³ *United Pac. Corp.*, 39 T.C. 721 (1963); *Estate of E.P. Lamberth*, 31 T.C. 302, 314-

Since an assumption of a mortgage is a promise of the buyer to pay off the mortgage debt, it presumably can be postponed until such time as the parties desire. Even merely taking property subject to a mortgage involves more, according to the Tax Court, than simply purchasing property that the mortgagee can view as security for the amount of the indebtedness. Although the buyer assumes no personal liability for the mortgage indebtedness, it must be satisfied out of the real property if the seller defaults on the payments. A provision that the seller is to make the payments on the mortgage debt until conveyance of the property indicates that there is no understanding between the parties that the debt is to be satisfied from the property sold.²²⁴ Thus, even though the mortgage exceeds basis, the seller does not realize his economic gain (created by the receipt of borrowed funds in excess of basis), because his obligation has in no way been diluted as it would have been by the injection of the buyer's promise (*vis-à-vis* the seller) that the debt was to be satisfied from the property. The cases that give effect to a postponement of the assumption charge the Commissioner with a strict interpretation of the language he used in his regulation. An agreement to assume the mortgage at a subsequent time is not viewed by the Tax Court as a contemporaneous assumption of the indebtedness. To do so, states the Tax Court giving full sway to the *form* of arrangement, would involve "a distortion of the agreement of the parties."²²⁵

If in a sale of encumbered property the mortgagee agrees to a novation substituting the buyer as the debtor personally liable and releasing the seller from his prior liability, the entire amount of the indebtedness must be treated as a payment in the year of sale. The novation represents full extinguishment of the seller's prior liability and is akin to a straight cancellation of indebtedness.²²⁶ The same reasoning should apply when extinction of the indebtedness is only partial, but the Commissioner has discarded cancellation-of-indebtedness principles in this area,

18 (1958), *not acquiesced in*, 1959-1 CUM. BULL. 6; *Stonecrest Corp.*, 24 T.C. 659 (1955), *not acquiesced in*, 1956-1 CUM. BULL. 6.

²²⁴ *Stonecrest Corp.*, 24 T.C. 659, 644-69 (1955), *not acquiesced in*, 1956-1 CUM. BULL. 6.

²²⁵ *United Pac. Corp.*, 39 T.C. 721, 728 (1963). The technique of postponed cancellation apparently may be employed with success when the seller's indebtedness to the buyer is cancelled at periodic times following the year of sale. In such instances the amount of the indebtedness is not treated as a payment in the year of sale. *Estate of Lipman v. United States*, 376 F.2d 455 (6th Cir. 1967).

²²⁶ There is dictum to this effect in *Ivan Irwin, Jr.*, 45 T.C. 544, 551 (1966). See also *Stephen A. Cisler*, 39 T.C. 458, 465 (1962). Selling taxpayers may now ask whether, upon analogy to *Stonecrest Corp.*, 24 T.C. 659 (1955), they may effectively postpone the novation to a subsequent year, thus removing potential qualification problems raised by the 30% rule.

because treatment of a pro rata payment of the assumed mortgage indebtedness as a payment in the year of sale could postpone collection of the tax on the income generated by the sale beyond the time during which the vendor would be directly receiving payments.

Although the Commissioner's revocation of otherwise operative cancellation-of-indebtedness principles received judicial blessing in *S. & L. Building*, it is unsettled to what extent these principles will continue to operate outside the relatively narrow field occupied by the applicable regulation.²²⁷ For example, the regulation refers only to mortgage indebtedness. In the recent case of *Ivan Irwin, Jr.*,²²⁸ the Tax Court concluded that, when liabilities of the seller other than a mortgage are assumed by the buyer as part of the transaction, the mere assumption of an indebtedness does not rise to the level of a cancellation, because the seller continues to remain liable. Not being analogous to a cancellation of indebtedness, mere assumption of third party liabilities is not a "payment" within section 453.

What, however, if the liability is *assumed and paid* in the year of sale, thus making the situation almost completely analogous to a cancellation of indebtedness? Perhaps fairly well accepted principles of indebtedness cancellation could be given heed, with the result that the amount assumed and paid during the year of sale would be treated as a payment during that year (thus threatening qualification with section 453(b)(2)(A)(ii)). Alternatively, the spirit of Treasury Regulation section 1.453-4(c) could be expanded to include situations not precisely within its terms, thereby reducing the risk with respect to the thirty percent rule. The split between these two points of view is neatly displayed in the opposing results reached in *Ivan Irwin, Jr.*, and *United States v. Marshall*,²²⁹ decided within nine days of each other in 1966. In both of these cases, the Commissioner argued that the portion of the seller's liabilities to third parties that was assumed and paid by the buyer in the year of sale constituted payment in that year.²³⁰ The Tax Court in *Irwin* decided the case solely on the ground that, whereas mere assumption does not result in "payment" to the seller, *assumption and payment* does create a payment. Only after finding that the selling taxpayers thus received more than thirty percent of the selling price in the year of sale did the court address itself to the possible application of

²²⁷ Treas. Reg. § 1.453-4(c) (1958).

²²⁸ 45 T.C. 544, (1966). See also Rev. Rul. 60-52, 1960-1 CUM. BULL. 186 and cases cited therein.

²²⁹ 357 F.2d 294 (9th Cir. 1966); *Ivan Irwin, Jr.*, 45 T.C. 544, 551-52 (1966).

²³⁰ The extreme position of the Commissioner in *Irwin* that *assumption* alone should compel treatment of the assumed amount as a payment was given no heed.

Treasury Regulation section 1.453-4(c). But the court found the regulation of little assistance, because no mortgage was involved. The court was "convinced that the regulation should be read to apply only to liabilities which are *assumed but not paid* in the year of sale."²³¹ This statement, of course, is erroneous, since the Supreme Court specifically held in *S. & L. Building* that a partial payment on an assumed indebtedness is not a payment in the year of sale.²³² In spite of this error, the court recognized that the essential problem was whether the spirit of the Commissioner's regulation was to be given heed beyond its specifically articulated scope. The court held that it was not.

United States v. Marshall involved the sale of a sole proprietorship to a corporation, which assumed (and paid in the year of sale) the accounts payable of the proprietorship. The Ninth Circuit reached a result contrary to *Irwin*, relying almost exclusively on the regulation. Stating that assumption of a mortgage is "analogous" to assumption of current business obligations, the court, citing *S. & L. Building*, noted that the unwanted possibility present there—postponement of the collection of the tax due beyond the period during which the seller would be directly receiving payments—was equally present in the *Marshall* situation. This similarity afforded a sufficient basis for the court to find the rationale of the regulation applicable with respect to transferred debt.²³³

It is difficult to choose between these two opinions. The symmetry produced by the *Marshall* result is appealing. Why should an assumed mortgage situation be different from an assumption of current business liabilities, if both produce the same ill? Although the authority cited by the Tax Court in *Irwin* is ample to support the view that an indebtedness is not a payment unless *assumed and paid*, the cited material concerned situations in which the *entire* indebtedness was assumed and

²³¹ 45 T.C. at 553 (emphasis in original).

²³² In subsequent litigation specifically involving a mortgage situation, the Commissioner seems to have taken the position, contrary to the interpretation placed upon Treas. Reg. § 1.453-4(c) (1958) in *S. & L. Building*, that first-year payments on an assumed mortgage constitute payments within the 30% rule. See Samuel Pollack, 47 T.C. 92, 113 (1966).

²³³ In a prior ruling, the Commissioner had little difficulty finding that the seller's unpaid balance, due a third party on a purchase of stock and assumed by the buyer in a sale of that stock, was "similar" to the assumption of a mortgage and therefore should not be treated as a payment in the year of sale. I.T. 2468, VIII-1 CUM. BULL. 159 (1929). This ruling, although not involving a payment of the assumed indebtedness, exhibits a proper willingness to expand the scope of Treas. Reg. § 1.453-4(c) (1958) to situations within its spirit if not its letter.

paid in a particular year.²³⁴ In such situations the ill that the Commissioner's regulation was designed to cure—deferring collection of the tax beyond the time the seller receives payments—is not present. Assume, for example, that the buyer sells assets, with a basis of \$500,000, for \$1,000,000. The consideration received is \$100,000 paid in the year of sale, the assumption and payment in the year of sale of \$200,000 in current business liabilities, and the execution of a note to the seller in the amount of \$700,000. The Tax Court would find qualification under the thirty percent rule, by treating \$300,000 as a payment in the year of sale; \$150,000 of the year-of-sale payment would be included in income in that year ($\$300,000 \times \$500,000 \div \$1,000,000$). Nevertheless, the problem of postponed collection, noted by the Supreme Court in *S. & L. Building*, would not be present.²³⁵ If only \$25,000 of the assumed business liabilities were paid during the year of sale, the Tax Court's treatment of \$125,000 as a payment that year would likely postpone collection on the tax beyond the time during which the seller would be receiving payments. Although the Supreme Court recognized that such a deferral is more than is necessary to meet the problem that prompted enactment of section 453, and that such deferral creates administrative problems, the Tax Court paid little attention to these ramifications. While this reveals the virtue of the *Marshall* opinion, it also demonstrates the inadequacy of the regulation. Since the regulation expressly covers only mortgage indebtedness, the Tax Court could easily read it literally and discount its importance, without seeing that the problem it meets is present when any form of third party indebtedness is involved.

Even if the *Marshall* result is correct, both *Marshall* and *Irwin* dealt only with taxpayer qualification under the thirty percent rule. If that threshold requirement is complied with, the quantum of income inclusion in each taxable period must be determined. For example, assume the taxpayer sells property, with a basis of \$5,000, for \$10,000, consisting of \$2,000 paid in the year of sale, assumed liabilities in the amount of \$2,000 (\$1,000 of which was paid in the year of sale), and a \$6,000 note calling for the payment of \$1,000 annually beginning in the year following sale. Although *Irwin* and *Marshall* would reach different

²³⁴ James Hammond, 1 T.C. 198 (1942); Wagegro Corp., 38 B.T.A. 1225 (1938); Rev. Rul. 60-52, 1960-1 CUM. BULL. 186.

²³⁵ If the note called for the payment of \$100,000 in each of the following years the taxpayer would include \$50,000 in income in each such year ($\$100,000 \times \$500,000 \div \$1,000,000$), thereby causing inclusion of the remaining \$350,000 realized gain in income while he is actually receiving payments.

results on the question of payments in the year of sale (\$3,000 and \$2,000, respectively), both interpretations recognize compliance with the thirty percent rule. But under the *Marshall* interpretation the taxpayer would be charged with \$1,250 of the realized gain in the year of sale ($\$2,000 \times \$5,000 \div \$8,000$), and with \$625 in each of the six years thereafter ($\$1,000 \times \$5,000 \div \$8,000$). This would account for the inclusion of the entire realized gain over a period during which the seller is actually receiving payments directly from the buyer.²³⁶

If the *Irwin* approach is followed, the mode of income computation is not exactly clear. The first of three possibilities²³⁷ would permit the taxpayer to include \$1,667 in income in the year of sale ($\$3,000 \times \$5,000 \div \$9,000$) and \$555.50 in each of the following years ($\$1,000 \times \$5,000 \div \$9,000$), thus catching the entire \$5,000 gain realized. Although this approach does not present the problem of postponed collection, it completely ignores the remaining \$1,000 of assumed liability that was not paid in the year of sale. Conceptually, this constitutes a failure of the approach and, perhaps, of the entire *Irwin* opinion. If the \$1,000 assumed and paid in the year of sale is a "payment" for the purpose of the thirty percent rule, as held in *Irwin*, the later satisfaction of the remaining indebtedness should also be a "payment" and should be included in the total contract price.

The second possible income computation under *Irwin* presupposes that "payment" means something different in section 453(b)(2)(A)(ii) from what it means in section 453(a). Thus, while the amount assumed and paid would be treated as a "payment" for purposes of the thirty percent rule, it would not be regarded as a "payment" that must be broken into its income and return-of-capital components for return under section 453(a). This effects the same income inclusion as was reached in *Marshall*, i.e., in the year of sale the taxpayer would include \$1,250 in income ($\$2,000 \times \$5,000 \div \$8,000$). Although this has the appeal of corresponding to *Marshall*, little justification appears in the statute or its history to permit the imposition of the varying treatment of the word "payment."

The third possibility, although the most reasonable, clearly por-

²³⁶ The noninclusion of the assumed liability in the total contract price seems dictated by Treas. Reg. § 1.453-4(c) (1958), and has the effect of increasing (over what might otherwise be the case) the proportionate amount of the gain that must be included in income each year. See *Pacheco Creek Orchard Co.*, 12 B.T.A. 1358 (1928); *Estate of Sam E. Broadhead*, 35 P-H Tax Ct. Mem. 146 (1966). But see G.C.M. 3048, VII-1 CUM. BULL. 60 (1928).

²³⁷ None of these possibilities were suggested in *Irwin*, of course, because the Tax Court found the sales in that case ineligible for return under § 453.

trays the difficulty of postponed collection. This view treats the taxpayer as having received \$1,500 income in the year of sale ($\$3,000 \times \$5,000 \div \$10,000$) and \$500 in each of the following six years as a result of payments on the note ($\$1,000 \times \$5,000 \div \$10,000$). This causes an income inclusion of \$4,500, with \$500 to be included when the buyer pays the remaining \$1,000 of assumed indebtedness. Not only does this approach potentially postpone collection until after the seller is directly receiving payments, but also it adds the difficulty that the seller must find out when the buyer pays the assumed indebtedness, an act which he might not be aware of without special and periodic effort.

The first two possibilities suggested have serious conceptual shortcomings, and the third suffers from the same ill that prompted adoption of the "mortgage rule."²³⁸ As long as the *Irwin* result potentially permits deferral beyond the time necessary to alleviate the problem resolved by section 453, it appears wise to extend the spirit of the mortgage rule to other areas not specifically within its scope. This, of course, is the *Marshall* result.

It must be apparent that confusion will exist as long as the regulation retains its present narrow scope. Presumably, the seller's continuing liability in an assumed indebtedness or "subject to" situation constitutes sufficient reason for concluding that the amount of the indebtedness should not be considered a payment for purposes of the thirty percent rule. Although at least one commentator takes the opposite view,²³⁹ there seems to be strong and sufficient reason to conclude that it is proper to treat an assumption *and* payment as a "payment" in the year of sale.²⁴⁰ A change in the regulations under section 453 would, however, be necessary to reach this result properly. Absent such a change, the *Marshall* court seems perfectly proper in analogizing the situation existing in that case with the regulation. If a regulation change incorporates the *Irwin* result with regard to payments in the year of sale, it should be accompanied by machinery that would prevent postponement of the seller's tax liability beyond the payout period. This may, as indi-

²³⁸ Treas. Reg. § 1.453-4(c) (1958).

²³⁹ See Comment, *Assumption and Discharge of Seller's Liabilities as Year of Sale Payments for Purposes of I.R.C. Section 453*, 16 BUFFALO L. REV. 758, 764-65 (1967), where the writer questions whether any payment not flowing directly to the seller should be treated as affecting his eligibility under § 453. He sees no distinction between situations involving assumption only and those marked by assumption and payment.

²⁴⁰ Certainly as long as the result reached in *Irwin* remains unchanged, those seeking use of § 453 should plan for the treatment of transferred debt as payment insofar as the 30% rule is concerned. See De Castro & Chodorow, *Can Buyer's Payment of Assumed Debt Kill Seller's Installment Election?* *Courts Disagree*, 25 J. TAXATION 130, 131-32 (1966) (discussing planning techniques in light of *Irwin*).

cated above, necessitate legislative change, because postponement of the seller's tax liability beyond the time during which he is receiving payments is always possible unless the assumed (but not paid) liability is not to be considered part of the total contract price. Not considering it part of the contract price would be an alteration of the present statutory scheme that may require the action of Congress.

B. *Payments Taking Other Forms*

1. *Advance Payments*

Identification of the year of sale is important, since that is the year to which the thirty percent ceiling must be applied.²⁴¹ Once the taxable year of sale has been determined, the question arises whether amounts paid by the purchaser prior to the commencement of that period are swept into it for purposes of the thirty percent rule. The problem has arisen in two contexts.

Occasionally the purchaser gives the seller a deposit or prepayment prior to the year of the actual sale. Although the parties clearly intend that the amount given to the seller prior to the time that they reach a binding agreement respecting the sale of the property will be applied toward the purchase price, it is unclear whether this advance payment (clearly not paid to the seller in the taxable year of sale) should be considered with respect to the seller's compliance with the ceiling on year-of-sale payments.²⁴²

In *Waukesha Malleable Iron Co. v. Commissioner*,²⁴³ the seller received an amount from a prospective buyer in return for the grant of an option to purchase property within a specific time. Because another party possessed a prior option to purchase the same property, the possibility existed that the option price would have to be returned. Moreover, the mode of taxation of the option price—either as a forfeited amount or as part of the purchase price—was uncertain until exercise or

²⁴¹ See pp. 229-31 *supra*. Although the statute as originally enacted bestowed qualification upon transactions in which the "initial payments" did not exceed the ceiling, that phrase was interpreted to include not simply the "downpayment" but also all payments made in the year of sale. Revenue Act of 1926, ch. 27, § 212(d), 44 Stat. 23. See Gertrude H. Sweet, 8 B.T.A. 404 (1927). This ambiguity does not exist under present law, the term "initial" having been dropped with enactment of the 1954 Internal Revenue Code.

²⁴² In 3 cases apparently dealing with this issue, the actual year-of-sale payments were themselves above the 30% ceiling. Thus, the court did not have to decide whether the advance deposit should be considered as part of the year-of-sale payments. *Warren Nat'l Bank v. Commissioner*, 61 F.2d 325 (3d Cir. 1932); *American Land & Inv. Co. v. Commissioner*, 40 F.2d 336 (4th Cir. 1930); *Newaygo Portland Cement Co.*, 27 B.T.A. 1097 (1933), *aff'd*, 77 F.2d 536 (D.C. Cir. 1935).

²⁴³ 67 F.2d 368 (7th Cir. 1933).

failure to exercise. Therefore, the court reasoned that the amount must be considered a payment in the year of sale.²⁴⁴

The policy behind section 453 certainly supports this result. There is no apparent reason not to include these prepaid amounts in determining whether the seller has sufficient liquidity to meet the tax liability generated by the sale. Yet, this result is not perfectly consistent with the statute, which decrees that "in the taxable year of the sale . . . payments . . . do not exceed 30 percent of the selling price."²⁴⁵ It is unclear whether the statute refers to the time of the receipt, regardless of whether it becomes a taxable item to the seller at that time, or whether the statute includes all those amounts that generate a tax effect to the seller in the year of sale. Obviously, the court in *Waukesha* viewed the income nature of the payment as crucial. Although the option price was received prior to the year of sale, its status as income was not determined until the sale. Thus, that became the proper time of "payment" for purposes of the ceiling on year-of-sale payments.

This reasoning, although not given great support by the statute, seems sound. Only amounts that are income producing to the seller (*i.e.*, includible as part of the amount realized in determining gain) should be considered in determining whether the taxpayer has received a sufficient amount to warrant a tax on the entire gain realized in the year of sale. Since the mere receipt of the option price was not income, it became proper to view it as a payment, for purposes of section 453(b)(2)(A)(ii), when it took on the status of income, *i.e.*, in the year of sale.²⁴⁶

This analysis becomes more difficult when the receipt prior to the taxable year of sale takes the form of an advance payment for property that is to be delivered at a later time. If the prepaid portion is received without restriction and without obligation to refund, then it must be viewed as income to the seller in the year of receipt.²⁴⁷ The statute, therefore, is unable to deal with the problem. If the sale is found to occur in a year subsequent to the year of prepayment, the use of section

²⁴⁴ See p. 229 *supra*.

²⁴⁵ INT. REV. CODE OF 1954, § 453(b)(2)(A).

²⁴⁶ The same result was reached in *Oakland & San Francisco Theatre Co.*, 11 P-H Tax Ct. Mem. 74 (1942), where the prior receipt was treated as received in the subsequent year of sale, its earlier use by the taxpayer being considered a loan. See also *Daniel Rosenthal*, 32 T.C. 225 (1959); *John F. Westrom*, 35 P-H Tax Ct. Mem. 1144 (1966) (the prior payment was viewed as a contingent deposit which did not become income until the later year of sale).

²⁴⁷ *E.g.*, *Fifth & York Co. v. United States*, 234 F. Supp. 421 (W.D. Ky. 1964); *Chester Farrara*, 44 T.C. 189 (1965). See generally *Abrams, Income Deferral: Problems, Techniques and Consequences*, N.Y.U. 25TH INST. ON FED. TAX. 577, 599-606 (1967).

453 seems dependent upon shearing off the previously taxed prepayment from the subsequent "sale" and payments, a course plainly not contemplated by the statute and for which there is no machinery.

2. Loans

Clearly, a loan to the seller by the buyer that is contemporaneous with the sale and creates an offsetting obligation to repay does not constitute a payment to the seller for section 453 purposes. This result should not be altered even though the loan is keyed into the contract of sale. In one case,²⁴⁸ the taxpayer received a loan from the publisher at the time a contract was executed for the sale (upon completion) of a manuscript by the seller-author. Since the loan was in fact to be repaid regardless of whether the manuscript was delivered, it was treated as a loan and not as an advance payment. As the ruling indicates, the situation may well be otherwise where the "loan" is not in reality an obligation that the seller will be called upon to repay.²⁴⁹

3. Disposition of Installment Obligations in the Year of Sale

Suppose that immediately after selling property for \$10,000 in cash and the buyer's four notes (\$10,000 each), the taxpayer sells two of the notes for slightly less than face. Clearly, within the taxable year of sale the seller is in a cash position that exceeds the year-of-sale ceiling. Despite early Board decisions to the contrary,²⁵⁰ it is now clear that the year-of-sale disposition of the installment obligations is regarded as independent of the transaction between vendor and vendee.²⁵¹ Although the statute refers only to payments in the year of sale and is silent concerning their source, presumably the legislative intent was to view only amounts paid by the purchaser (and not by a third party transferee of the purchaser's note) in applying the year-of-sale ceiling. Of course, section 453(d), dealing with the disposition of installment obligations, would compel inclusion in income of a certain amount of that paid by the third party.²⁵² The regulations now provide that the installment method is still available to the seller with respect to the notes of the

²⁴⁸ Rev. Rul. 234, 1953-2 CUM. BULL. 29.

²⁴⁹ *E.g.*, James Hammond, 1 T.C. 198 (1942).

²⁵⁰ *E.g.*, Mrs. W.M. Bludworth, 7 B.T.A. 495 (1927).

²⁵¹ The old line of authority was first overruled by *Duram Bldg. Corp. v. Commissioner*, 66 F.2d 253 (2d Cir. 1933).

²⁵² The effect of § 453(d) is such that, if all the installment obligations held by the seller are disposed of at face, the result will be the same as if the taxpayer had not elected the installment method. This result, of course, squarely raises the problem of what constitutes a disposition within § 453(d). See *Winding River Ranch, Inc.*, 35 P-H Tax Ct. Mem. 1494 (1966). The problem is outside the scope of this article.

buyer not disposed of, even though deferral is lost with respect to the obligations that were sold.²⁵³

C. *The Relevance of Mistake*

It is proper to infer that the statute refers to actual payments received by the seller, even though the contractual arrangement between the parties calls for the payment of a greater or lesser amount.²⁵⁴ This raises the question whether compliance with section 453 can be achieved by returning to the buyer a portion of what the seller received in the taxable year of sale. If the year-of-sale payment is modified during the year of sale, only what the seller actually received and kept should be considered in determining qualifications. Further, if the sale has been consummated in a manner not qualifying under section 453, the seller, even with the agreement of the buyer, should not be able to "reform" the agreement subsequent to the year of sale by returning a portion of the amount received during the year of sale in an effort to bring the "net" amount received by the seller below the ceiling. This seems to be the position of the Commissioner, who has ruled in a remotely analogous situation that the "seller may not alter the form of the sale so as to permit him to report the gain realized . . . on the installment method."²⁵⁵

The concept of mistake, however, may deserve consideration. In *Lewis M. Ludlow*,²⁵⁶ the seller of stock in a closely held corporation had, during the negotiations leading to establishment of the purchase price, clearly communicated his desire to have the transaction eligible for return under section 453. The purchaser was agreeable to the plan. Through an error in the computation of the amount to be received in the year of sale, however, the seller actually received slightly more than thirty percent of the selling price. The error was discovered the day after the contract closing (December 29), and the excess over thirty percent was immediately returned to the buyer, who did not receive it until

²⁵³ Treas. Reg. § 1.453-4(c) (1958).

²⁵⁴ E.M. Funsten, 44 B.T.A. 1166 (1941); James D. Boone, 27 B.T.A. 1064 (1933); First Sav. & Trust Co., Ex'r, 20 B.T.A. 272 (1930). Of course, reference is also made to those amounts constructively received. See note 55 *supra*. An amount required to be deposited by the seller with a lending institution as a guarantee of the buyer's obligation to the lender is actually an amount withheld by the lender, and is a payment within the year of sale. Key Homes, Inc., 30 T.C. 109 (1958), *aff'd per curiam*, 271 F.2d 280 (6th Cir. 1959).

²⁵⁵ Rev. Rul. 56-20, 1956-1 CUM. BULL. 197, 198, which deals with the right of a seller to alter the form of a cash sale after receipt in order to get the benefits of the installment method. The Commissioner held that once the full balance of cash was accepted the nature of the transaction was fixed for income tax purposes.

²⁵⁶ 36 T.C. 102 (1961).

January 1. In finding that the sale qualified for return under section 453, the court reasoned that the taxpayer received the excess "under a mistake, mutually recognized, and not under a claim of right."²⁵⁷ The opinion gives every indication that the same result would have been reached if the error had been discovered in March and the amounts returned to the buyer at that time. In an area fraught with technical traps, this result is soothing. The mutuality of the error, however, presumably is requisite to the result. The purchaser's willingness to pay more than the ceiling on year-of-sale payments should not prevent the parties from planning to bestow upon the seller the income deferral sanctioned by section 453.²⁵⁸ If, through error that can truly be described as mutual, this permissible goal of the parties is not achieved, judicial recognition of the correction of that mistake is welcome. The court is on weak ground, however, when it attempts to found its result on claim-of-right principles. As the dissenting judges point out, there was no doubt that, as between the parties, the seller had a right to retain the over-ceiling amount. The judicial doctrine of claim of right would never absolve the taxpayer from inclusion in income of these mistakenly, but rightfully, received amounts.²⁵⁹

D. *Evidences of Indebtedness*

Only evidences of indebtedness of the purchaser can be received outside the thirty percent rule. The indebtedness acknowledged by the buyer at the time of sale will almost always be expressed in a written agreement. On the rare occasion that the buyer's promise to pay the remaining balance is only orally expressed, the seller's eligibility to return the profit under section 453 should not be prejudiced.²⁶⁰ Clearly, a situation in which the taxpayer sells property with a basis of \$100 for a \$20 down payment and the buyer orally promises to pay the remaining \$80 of the purchase price is conceptually within the realm of transactions that prompted the enactment of section 453. The taxpayer should be entitled to return the gain therefrom under section 453. Of course, absent an election under the section, the taxpayer would obtain a form of deferral as a result of the conclusion that the buyer's "oral promise" did not have a "cash equivalent."²⁶¹

²⁵⁷ *Id.* at 110.

²⁵⁸ *E.g.*, Charles A. Collins, 48 T.C. 45 (1967), *acquiesced in*, 1967 INT. REV. BULL. No. 40, at 6.

²⁵⁹ *United States v. Lewis*, 340 U.S. 590 (1951). *See generally* Lister, *The Use and Abuse of Pragmatism: The Judicial Doctrine of Claim of Right*, 21 TAX L. REV. 263, 275-76 (1966).

²⁶⁰ *E.g.*, Vincent P. Vigilante, 35 P-H Tax Ct. Mem. 957 (1966).

²⁶¹ *See* note 12 *supra*.

Defining what is an evidence of indebtedness does not create many problems. An early Board opinion takes the view that the sale of real estate to a corporation for the sole consideration of two ten-year bonds did not constitute a qualifying installment sale.²⁶² To the extent that the opinion is premised upon the idea that there was no provision for the payment of installments, it is archaic and does not reflect current law. It must be regarded as erroneous to the extent that it is based on the idea that the bonds, having a higher degree of marketability and negotiability than would the purchaser's promissory note, should not be viewed as evidences of indebtedness. The statute must be read as eschewing considerations involving degrees of marketability. For tax payment purposes the receipt itself of bonds or notes fails to bestow liquidity upon the selling taxpayer.

Of course, this conclusion does not exclude the possibility that certain obligations received will be viewed as equity interests and not as evidence of indebtedness. The Commissioner may contend that the nominal nature of bonds issued by a corporate purchaser should be cast aside in favor of the true equity nature of the instrument. The line between debt and equity with regard to senior security interests has become blurred and may not be of great economic significance. But if the interest received by the selling taxpayer is of a more proprietary character, he will be charged with the receipt of property other than an evidence of indebtedness, and therefore will not qualify for the income deferral of section 453. On the other hand, a selling taxpayer should be able to treat what is nominally preferred stock as an evidence of indebtedness, if the circumstances so warrant. In wrestling with the old chestnut of debt-versus-equity in other contexts, the judiciary has hammered out adequate criteria.²⁶³ There seems to be no reason why such considerations should not be relevant in determining the applicability of section 453.

The relevance of these considerations to section 453 was touched upon, albeit tangentially, in *Wilson & Fields*.²⁶⁴ Because the preferred stock received by the seller in that case was found to have been received as security for the payment of the outstanding obligation of the purchaser, the court was not compelled to pass upon the Commissioner's contention that the preferred stock was not an evidence of indebtedness within section 453(b)(2)(A)(ii). The opinion, however, plainly indicates

²⁶² Thomas F. Prendergast, Ex'r, 22 B.T.A. 1259 (1931).

²⁶³ See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* §§ 4.02-.07 (2d ed. 1966).

²⁶⁴ 31 P-H Tax Ct. Mem. 1189 (1962).

that the court was prepared to enter the well-trod realm of debt-versus-equity if it had been necessary.

The statute is clear that qualifying evidences of indebtedness must be "of the purchaser."²⁶⁵ And yet, receipt of the indebtedness obligations of one other than the purchaser in the year of sale causes income tax to be generated to the seller on amounts yet to be received.²⁶⁶ The sparse legislative history concerning the words "of the purchaser" indicates that Congress did not contemplate the third party note problem, but rather was intent upon not allowing income deferral through an installment method election when the seller receives more marketable evidences of third party indebtedness, such as Liberty Bonds.²⁶⁷

The question arises whether the endorsement of the purchaser upon the note of a third party will transform it into an "indebtedness of the purchaser." Since the Uniform Commercial Code casts the endorser's liability in the form of a surety and does not call for payment until the instrument is dishonored and necessary notice of dishonor is given,²⁶⁸ an endorsement by the purchaser apparently would not convert the instrument into an evidence of the purchaser's indebtedness. This interpretation presumes that section 453(b)(2)(A)(ii) contemplates a present indebtedness of the purchaser. While potential liability may befall the endorser, he has not acknowledged a present indebtedness. A contrary conclusion must be reached when the purchaser is a co-maker of a note, the other maker not being a purchaser. Although the purchaser's indebtedness is joint, it is also several, and therefore must be classified as his indebtedness.²⁶⁹

If an "evidence of indebtedness" includes any written contractual promise to pay, a check, defined as "an unconditional . . . order to pay a sum certain in money . . . on demand . . .,"²⁷⁰ is within the phraseology of section 453. Co-existing with this postulate in the commercial sphere, however, is a set of principles, applicable in the income tax area, to the effect that checks are usually required to be included in income in the

²⁶⁵ INT. REV. CODE of 1954, § 453(b)(2)(A)(ii).

²⁶⁶ *Walnut Realty Trust*, 23 B.T.A. 850 (1931); *Georgia-Florida Land Co.*, 16 B.T.A. 1253 (1929); *J.W. Elmore*, 15 B.T.A. 1210 (1929); see p. 206 *supra*.

²⁶⁷ 67 CONG. REC. 3282 (1926) (remarks of Senator Smoot).

²⁶⁸ UNIFORM COMMERCIAL CODE § 3-414. See also G.C.M. 11846, XII-1 CUM. BULL. 113, 115-16 (1933).

²⁶⁹ The phrase "evidences of indebtedness" in INT. REV. CODE of 1954, § 1232 (dealing with the retirement of bonds and other evidences of indebtedness) similarly lacks a clear definition.

²⁷⁰ UNIFORM COMMERCIAL CODE §§ 3-104(1)(b), 2(b).

year in which they are received.²⁷¹ Decisions concluding that the time of the receipt of the check should determine the time of its inclusion in income are premised upon either the doctrine of constructive receipt or upon the common law doctrine of conditional payment and relation back. If these principles are to be given sway with respect to section 453, the technical nature of a check as an evidence of indebtedness in the commercial realm must be disregarded, and the taxpayer should be considered as having received payment in a form so proximate to cash that it must be viewed as such and not as an evidence of indebtedness.²⁷² Of course, if the selling taxpayer receives a partial payment in the form of an order to pay at a definite time in the future, he is not in constructive receipt of the promised amount, and the draft should be treated as an "evidence of indebtedness" for purposes of section 453.

E. *More on Identification of the "Taxable Year of Sale"*

Identification of the "taxable year of sale" is manifestly important with regard to both applying the ceiling on payments and determining the proper time for electing the installment method. Since there is no federal law of sales, local law, though not conclusive, must play a role in determining the time of sale.²⁷³ With regard to real property, the Regulations clearly state that "agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid" qualify as transactions eligible for return under section 453.²⁷⁴ Thus, title passage is eschewed as the central criteria for determining the time of sale. Although title may be reserved for purposes of security, the agreement must create an unconditional obligation to sell and an unconditional obligation to buy.

In *Commissioner v. Stuart*,²⁷⁵ the parties agreed upon a sale of certain realty in 1954, and payments that year totalled \$15,000. The

²⁷¹ See Note, *Checks and Notes as Income When Received by a Cash-Basis Taxpayer*, 73 HARV. L. REV. 1199, 1200-02 (1960).

²⁷² See *Spiegelberger v. United States*, 1 Am. Fed. Tax R.2d 1435 (S.D. Cal. 1958), where the purchaser prepaid (by check) an installment on the note, and as a result the seller received amounts in excess of the 30% ceiling.

²⁷³ See generally *Lucas v. North Texas Co.*, 281 U.S. 11 (1930); Chapman, *Time of Sale Under the Internal Revenue Code*, N.Y.U. 22d INST. ON FED. TAX 139 (1964). The term "taxable year of sale" must include the period for the computation of taxable income applicable to the particular taxpayer. I.T. 2492, VIII-2 CUM. BULL. 120 (1929). Thus, if the seller dies during the year of sale, the relevant period for the ceiling on year-of-sale payments would be the "short period" provided for in § 443(a)(2).

²⁷⁴ Treas. Reg. § 1.453-4(a)(1) (1958). See *Floyd R. Clodfelter*, 48 T.C. 694 (1967).

²⁷⁵ 300 F.2d 872 (3d Cir. 1962). See also *John F. Westrom*, 35 P-H Tax Ct. Mem. 1144 (1966).

closing and transfer of a warranty deed were to take place in April 1955. In the event the buyer failed to make any of the agreed payments or failed to close in the manner agreed upon, all prior sums paid by the buyer were to be forfeited to the seller as liquidated damages. The Commissioner viewed the sale as taking place in 1955 and, since the seller received more than thirty percent of the selling price at the time of closing, denied the taxpayer the use of section 453. This position was upheld by the court of appeals.²⁷⁶ Since the buyer, upon forfeiture of the amount paid, could be released from the obligation to purchase, the court viewed the transaction as akin to an option to buy, which was exercised at the closing in 1955. Although the 1954 agreement was an enforceable contract for the sale of real property,²⁷⁷ a result contrary to that reached by the court would violate the general principles of taxation of options and would pose significant administrative problems in the event the buyer chooses not to close the agreement and forfeits the amounts previously paid.

The result in *Stuart* is not inconsistent with *Wiseman v. Scruggs*.²⁷⁸ In that case, the parties to a sale of real property entered a written contract in 1954, which called for a selling price of \$40,000. The buyer paid \$10,000 at the time of the 1954 agreement and agreed to pay the balance in annual installments of \$8,000 beginning the following year. The agreement further provided that upon the payment of each installment the seller would convey a portion of the unimproved tract. The contract was carried out according to its terms, and the buyer's possession of the entire tract from the date of the 1954 agreement was never challenged. The problem of pinpointing the time of sale arose because the sellers, who elected to report the gain from the sale under section 453 on their return for 1954, subsequently filed a claim for refund in which they urged that the transaction was in reality several sales of realty consummated in each of the several years subsequent to 1954. The court of appeals found that the contract obligated the sellers to execute and deliver deeds in later years, obligated the buyer to make subsequent payments, and gave untrammelled possession to the buyers. This was a sufficient basis for the court to conclude that the transaction was one sale that occurred in 1954. Therefore, over the taxpayer's apparent objection, he was charged with his prior choice of the installment method.

In *Scruggs* the court was concerned with the tax treatment to be

²⁷⁶ 300 F.2d at 876.

²⁷⁷ *Id.* at 875.

²⁷⁸ 281 F.2d 900 (10th Cir. 1960).

accorded the \$10,000 paid at the time the contract was executed. In an option situation such that as in *Stuart*, the seller was properly allowed to treat the amount as a nontaxable receipt at that time; determination of the type of tax to be imposed on that amount must await the buyer's action on the option. In a nonoption situation, however, the seller's receipt of an amount to be applied toward the purchase price must generate an immediate tax effect. This being the case, every effort should be made to find that the year of that taxable receipt constitutes the taxable year of sale, regardless of when formal closing is to be completed; otherwise, the difficulties previously mentioned,²⁷⁹ occasioned by the receipt of a taxable amount prior to the year of sale, present themselves. This usually can be accomplished through the application of general contractual principles relating to contract formation and the existence of a firm offer and acceptance.²⁸⁰

F. *Split Sales*

Immediately related to the above dilemma is the determination of the subject matter of the sale. As hinted in *Wiseman v. Scruggs*, the taxpayer may gain by claiming that the deal was in fact more than one sale transaction and that each should be applied against section 453 to determine qualification.²⁸¹ Of course, the Commissioner may desire to split the sale so that two or more parts fail to qualify.²⁸² The first problem is the extent to which form will control. For example, when two groups of assets of the same character are sold to the same vendee at the same time, but the transaction is cast as two separate contractual arrangements, the regulations *seem* to indicate that each transaction should be separately analyzed to determine its eligibility for return under section 453.²⁸³ The seller's effort to cast the transaction into separate

²⁷⁹ See pp. 243-45 *supra*.

²⁸⁰ The same principles should apply with respect to sales of personalty. The distinction between executory and executed sales (with the former not constituting a sale for § 453 purposes) relied upon in Rev. Rul. 234, 1953-2 CUM. BULL. 29, 31, no doubt has continuing vitality despite different phrasing in UNIFORM COMMERCIAL CODE § 2-106(1). See Rev. Rul. 67-100, 1967 INT. REV. BULL. No. 14, at 9, which indicates that the Commissioner regards the closing date as significant in spotting the time of sale, even though there was a prior contract for sale.

²⁸¹ E.g., *Nathan C. Spivey*, 40 T.C. 1051 (1963); *Buckeye Engine Co.*, 11 B.T.A. 318 (1928). If the taxpayer urges separate sales, proper apportionment raises problems of proof. See *Blackstone Realty Co., Inc.*, 35 P-H Tax Ct. Mem. 930 (1966).

²⁸² E.g., *Divine v. United States*, 10 Am. Fed. Tax R.2d 5403, 5409-10 (W.D. Tenn. 1962).

²⁸³ Treas. Reg. § 1.453-5(a) (1958), which calls for the separate treatment of each transaction, gives no hint of a different result if the vendee is identical in two or more otherwise separate sales.

sales should be honored. Cases in this area acknowledge that the installment method should be available to those who follow the formal procedures by which it is defined.²⁸⁴ Consequently, if the taxpayer's negotiations with the buyer for the sale of fifty acres for \$250,000 reveal that the buyer desired to pay \$100,000 cash together with \$150,000 in evidences of indebtedness, the seller should be allowed to cast the transaction such that twenty acres are separately sold for \$100,000 in cash and thirty acres are sold for \$150,000, with the purchaser giving his evidences of indebtedness. If the separateness of the sales is honored, the taxpayer will have preserved his section 453 opportunity with respect to a significant portion of the aggregate gain involved.

This concession to form should not be troublesome when the transactions are so clearly separate. A recent Tax Court decision indicates, however, that that tribunal is willing to preserve the seller's installment method opportunity even when the separate nature of the transactions is not very distinct. In *Charles A. Collins*,²⁸⁵ the taxpayer sold some fifty-two acres for approximately \$260,000. The entire sale was handled as one transaction, the buyer receiving the deed in the year of sale. The consideration for the sale was paid in the form of \$20,000 upon the execution of the agreement, \$95,000 at closing, and a \$145,000 mortgage on the property. Because the buyer desired to begin developing the purchased property and presumably because of the substantial down payment, the mortgage covered only thirty-two acres of the tract sold. Although the seller received amounts in excess of the ceiling in the year of sale, the Tax Court, using reasoning that can best be described as surrealistic, found qualification for part of the transaction by shearing off the part involving the mortgage and classifying it as a separate sale. This curious result would have been justified if there had been some indication (other than on the taxpayer's return for the year of sale) that the seller had intended to cast the transaction as two sales. But the mere fact that the mortgage indebtedness ran only to a portion of the property does not seem a sufficient basis for severing what is otherwise a unitary event. The decision in *Collins* has cast a cloud of uncertainty over the entire problem and raises questions concerning what the proper criteria are for splitting the sale.

A multiple-vendor approach to the sale of property by co-owners has achieved what must be viewed as the correct result. For example, suppose that co-tenants *A* and *B* sell their property for \$300,000. If *A* desires to receive all cash and *B* wishes to defer his gain under section

²⁸⁴ E.g., *James Hammond*, 1 T.C. 198, 205 (1942).

²⁸⁵ 48 T.C. 45 (1967), *acquiesced in*, 1967 INT. REV. BULL. No. 40, at 6.

453, an approach that regards *A* and *B* as having separately sold their one-half interest in the property will permit *B* to obtain the wanted income deferral. On the other hand, if the sale is regarded as a single transaction and the buyer pays *A* \$150,000 in the year of sale, then the total consideration paid by the buyer in the year of sale exceeds thirty percent of the total selling price paid for both interests. The statute is not very helpful on this question, simply stating that qualification is dependent upon payments not exceeding thirty percent of the selling price.²⁸⁶ Thus, if "payments" refers to the amount paid by the buyer, qualification would seem prohibited. In *Timanus v. Commissioner*,²⁸⁷ the court adopted the approach that each co-owner is regarded as selling his interest, and determined the selling price for that interest on a pro rata basis. If this approach is applicable to tenancies in common and to joint tenancies, as it should be, the way is open for a selling co-owner to obtain deferral under section 453 even though the other party or parties are not eligible.²⁸⁸

G. Sale of a Business

Unique problems are presented in the sale of a business. The teaching of *Williams v. McGowan*²⁸⁹—that such a transaction is to be "cominuted into its fragments" and the result applied against the capital gains provisions to determine the nature of the gain or loss—is now widely accepted. Does this fragmentation process affect application of section 453(b)(2)(A)(ii)? One year before *Williams*, the Tax Court, in *Arkay Drug Co.*,²⁹⁰ decided that the sale of assets by a corporation did not qualify for the installment method, because the seller received more than thirty percent of the selling price in the year of sale. Refusing to notice that the contract allocated the total consideration to the various items being sold by the corporation (e.g., \$10,000 for inventory, \$2,000 for fixtures), the court no doubt was influenced by the idea of "*universitas facti*" extant prior to *Williams*.

²⁸⁶ As originally enacted, the statute described the ceiling upon year-of-sale payments as a specified percentage of the "purchase price." Revenue Act of 1926, ch. 27, § 212(d), 44 Stat. 23. Although the change to "selling price" in 1928 was made because it was "less confusing," it supports a more rational result when property held by co-owners is sold to a single vendee. H.R. REP. NO. 2, 70th Cong., 1st Sess. 15 (1927).

²⁸⁷ 278 F.2d 297 (4th Cir. 1960).

²⁸⁸ The contract between the selling co-owners and the purchaser should reflect the allocation of the year-of-sale payment between the sellers, because an independent agreement between the sellers will not be binding with regard to eligibility under § 453. *Walter E. Kramer, Ex'r*, 27 B.T.A. 1043, 1053 (1933), *appeal dismissed*, 80 F.2d 1014 (7th Cir. 1935).

²⁸⁹ 152 F.2d 570, 572 (2d Cir. 1945).

²⁹⁰ 13 P-H Tax Ct. Mem. 1301 (1944).

If the fragmentation of the sale compelled by the *Williams* decision applies for purposes of determining eligibility under section 453(b), then the payment in the year of sale would presumably be allocated on a pro rata basis to each class of items, and an independent determination of eligibility would be made for each class.

The usual obstacle to qualification would be the thirty percent ceiling on year-of-sale payments. This will probably be the case, however, only when the initial payment exceeds thirty percent of the aggregate value of the assets, since the allocation of the year-of-sale payments would most reasonably be effected on the basis of selling price or value. If the portion of the initial payment so allocated does not exceed thirty percent of the amount of the total selling price allocated by the parties to the realty, for example, the gain recognized thereon would presumably be subject to deferral. However, the nature of the property itself, and not merely the application of the thirty percent ceiling, plays a role and conceivably could prevent the gain from the sale of the inventory portion of the seller's asset package from qualification under section 453(b), because the statute specifically renders inventory property ineligible subject matter for a casual sale of personalty.²⁹¹

The threshold question, however, is whether the allocation procedure fostered by the *Williams* decision is a proper tool for solving problems arising under section 453. The dilemma which that decision met and solved—the determination of the nature of gain or loss generated by the sale of the business—is quite distinct from eligibility determination under section 453(b). Although the Commissioner has ruled that “the selling price must be allocated among all the assets sold according to the respective relative values thereof,”²⁹² with the allocation made by the parties themselves being given considerable heed, the aim of the ruling is to effect the mandate of *Williams*.

There appears to be no statutory authority for fragmenting a single sale into separate parts, based upon classes of assets, for the purpose of determining qualification under section 453(b). That statute refers to the “year of the sale” and “the selling price” and carries no hint of a fragmentation process in the event that assets of different types, eligible and ineligible, are involved in “the sale.” The Commissioner recognizes as much when he states:

²⁹¹ INT. REV. CODE OF 1954, § 453(b)(1)(B). Inventory property is seemingly ineligible even though its disposition is part of an otherwise “casual” disposition (e.g., the sale of a sole proprietorship, which is “casual” at least to the extent that it is infrequent).

²⁹² Rev. Rul. 55-79, 1955-1 CUM. BULL. 370.

In the case of an installment sale, allocation of the down payment ordinarily presents no problem, since it usually represents a fixed percentage of the selling price of all the assets included in the sale.²⁹³

Nevertheless, when a bundle of assets is sold for a single price to be paid in installments and that asset package contains property ineligible for the installment method, some procedure must be evolved to isolate the tainted property, lest the entire sale fail to qualify. The allocation made necessary by *Williams* seems a likely vehicle.

Although not exactly apposite, there is some administrative authority for the allocation of year-of-sale payments. In one ruling²⁹⁴ the taxpayer sold a resort business that included a liquor business for the total price of \$500x, \$140x being paid in the year of sale. A local regulation of the liquor control commission required the buyer to make a down payment of at least forty percent in the sale of a liquor business. To satisfy the requirement, the parties provided in the agreement for a \$460x/\$40x allocation of the selling price between the resort business and the liquor business, respectively. They further provided that the down payment for the liquor business should be considered forty percent of \$40x, or \$16x. The Commissioner stated that allocation of the down payment is not usually necessary in a sale of an asset package, but recognized that "the conditions of a particular case may require a separate allocation of the down payment."²⁹⁵ He approved an allocation that would "conform to the local legal requirements to which the sale was subject."²⁹⁶

Of course, in this case the allocation of the year-of-sale payment was in accordance with a legal requirement and was not the result of bona fide negotiation between the parties. Nevertheless, the Commissioner did approve an allocation of the down payment, based upon *Williams* principles, when "the conditions of a particular case may require." Is the inclusion of ineligible property (inventory) in the asset package a "condition" that warrants rational allocation of the down payment among the various properties? An affirmative answer is necessary if section 453(b) is to be of use in the sale of many businesses. If the initial payment does not exceed thirty percent of the selling price of all the assets, the sale should not be rendered ineligible merely because ineligible property is included among the assets sold.

²⁹³ Rev. Rul. 57-434, 1957-2 CUM. BULL. 300, 301.

²⁹⁴ Rev. Rul. 57-434, 1957-2 CUM. BULL. 300.

²⁹⁵ *Id.* at 301.

²⁹⁶ *Id.*

An allocation—whether made by the parties as part of the agreement or as a necessary antecedent to the proper return of the income from the sale—can function also as the basis for the down payment. Despite the half step taken toward this result in the ruling, the Commissioner's litigation policy indicates that he will attempt to treat the sale of business assets as a unitary event, in an effort to disqualify transactions through noncompliance with the thirty percent rule.

In both *Andrew A. Monaghan*²⁹⁷ and *Lubken v. United States*,²⁹⁸ the Commissioner took the position that the sale of a business (which included inventory property) was ineligible under section 453(b) since the seller, in the taxable year of sale, received more than thirty percent of the selling price. By finding that in each instance the inventory was sold as part of a separate transaction, each court was able to find for the taxpayer, because in a separate transaction, the amount paid for the inventory was not considered in determining whether or not the remainder of the property was eligible for return under section 453. Even if there is no evidence indicating that inventory is separately bargained for and purchased, as may often be the case, the Commissioner must agree to some allocation as the only reasonable method to carve out the ineligible property. In such instances, the *Williams* allocation is doing service beyond that intended, but in a manner that constitutes a reasonable extension of that holding.²⁹⁹

²⁹⁷ 40 T.C. 680 (1963). After noting that an allocation of the down payment is not required in the usual installment sale, the court stated:

An allocation is material, however, when there is a sale of a going proprietorship with an explicit amount received for property excluded by the terms in parentheticals of section 453(b)(1)(B), such as in the instant case since only the payment for the business was to be made in installments, while the separate agreement for the remaining inventory provided for payment in cash. In such cases it is our conclusion that the sale of inventory for a separate price will not be included in determining whether the 30-percent limitation will prevent installment reporting for the sale of the other assets.

Id. at 687-88.

²⁹⁸ 8 Am. Fed. Tax R.2d 5073 (S.D. Cal. 1961).

²⁹⁹ This position draws some support from the statute. The 30% test constitutes a limitation on the application of ¶ (1), which contains the language relative to the ineligibility of inventory property. Thus, since the 30% ceiling applies only to eligible property, there is some basis upon which the inventory portion of the transaction can be sheared off and treated separately for both 30% ceiling and property eligibility purposes. The results in *Monaghan* and *Lubken*, however, indicate the advisability of casting the sale of inventory as a transaction separate from the disposition of the other assets. *But see* *Cortland Specialty Co.*, 22 B.T.A. 808, 816 (1931), *aff'd*, 60 F.2d 937 (2d Cir. 1932).

Subsequent to the preparation of this article the Commissioner provided more specific guidance for allocation of year-of-sale payments to inventory and to that portion of the asset package which is sold at a loss. Rev. Rul. 68-13, 1968 INT. REV. BULL. No. 2, at 8.

Amounts paid by the buyer that are allocated by the parties to a covenant not to compete create an analogous problem. Amounts received pursuant to such an understanding are not eligible for return under section 453, because they are not received as a result of a "sale or other disposition of property."³⁰⁰ When the parties allocate an amount to the covenant and that allocation is upheld for purposes of the general income tax results which flow from the existence of a covenant,³⁰¹ the property disposition and covenant portions of the transactions must be severed for the purposes of section 453. But a covenant can have ripple effects in the section 453 area that may result in disqualification.

In *Balthrope v. Commissioner*,³⁰² the taxpayer agreed to sell the stock in a corporation operating a radio station for \$442,000, an amount that apparently represented the reasonable value of the stock. On the eve of execution of the contract, the buyer asked the seller to take \$150,000 of the selling price "as a covenant not to compete, or consulting contract, or any way you want to do it."³⁰³ Since the seller's illness had prompted the sale in the first place, he readily agreed to the covenant not to compete for a period of ten years and to render consulting services, for which, according to the allocation effected, he was to receive \$15,000 annually for ten years. The stock sale was cast in terms of \$100,000, paid in the year of sale, with the remainder to be paid in subsequent installments. Hoping to preserve his eligibility under section 453, the taxpayer argued that the selling price was \$442,000 and that the allocation of \$150,000 for consultative, noncompetitive purposes was a sham, and actually represented payment for the stock or goodwill. Using tested criteria,³⁰⁴ the court found that the seller in fact agreed to exchange his services and right to compete for \$150,000, and therefore the selling price for the stock was only \$292,000 and section 453 was unavailable. This decision shows the necessity for care when an agreement not to compete is part of a trans-

³⁰⁰ Deferral of the amount allocated to the covenant can be obtained by the covenantor through the simple device of having the covenantee pay the amounts annually over the life of the agreement. Barnet, *Covenants Not To Compete: Their Effects upon the Covenantor and Covenantee*, N.Y.U. 18TH INST. ON FED. TAX. 861, 876 (1960).

³⁰¹ See *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), upholding the allocation effected by parties in the absence of a showing of fraud or undue influence.

³⁰² 356 F.2d 28 (5th Cir. 1966).

³⁰³ *Id.* at 29.

³⁰⁴ *Id.* at 34; see, e.g., Note, *Tax Treatment of Covenants Not To Compete: A Problem of Purchase Price Allocation*, 67 YALE L.J. 1261 (1958). If the covenant is found not to have been separately bargained for, the seller's choice of the installment method should not be hindered by the presence of a covenant. Rebecca J. Murray, 28 B.T.A. 624 (1933). But see note 305 *infra*.

action in which the seller wishes to utilize the installment method of reporting income.³⁰⁵

VI

OPERATIVE EFFECT OF SECTION 453

The deferral effect of a valid election under section 453 is clear. As a result of the machinery contained in section 453(a), each installment payment received by the taxpayer consists of a portion of a return of the seller's basis and a portion of the gain realized on the transaction. The manner in which repossession of the property sold or disposition of installment obligations can significantly alter the obtained deferral is outside the scope of this discussion.³⁰⁶

If subsequent events effect a reduction in the selling price, there is no change in gross profit previously reported. The amount of income to be reported in future installments is lessened by the amount of the price reduction; the adjusted amount is spread over the remaining installments.³⁰⁷ When the reduction exceeds the income still to be reported, the loss is taken in the year of the price reduction.³⁰⁸

Naturally, use of section 453 does not alter the seller's right to obtain preferential treatment under the capital gains provisions. In a changing statutory context, it may be important to determine whether the law in effect at the time of sale should control the mode of taxation or whether the subsequent installment receipt should be subject to the statutory pattern existing at the time of receipt. This dilemma is best considered in light of an analogous problem. The effect of section 453 is to defer income to another taxable period. The conclusion is easily reached that subsequent installment receipts should be taxed at rates that exist at the time of the later receipt. From this fairly clear result, the court in *Snell v. Commissioner*³⁰⁹ quickly concluded that the receipt of installment payments as a result of a sale returned under section 453

³⁰⁵ This problem is still present when the parties make no allocation to a covenant, since in some circumstances the court makes an independent allocation, or upholds a unilateral allocation by the covenantor. *E.g.*, *Wilson Athletic Goods Mfg. Co. v. Commissioner*, 222 F.2d 355 (7th Cir. 1955); *Rodney B. Horton*, 13 T.C. 143 (1949), *appeal dismissed*, 180 F.2d 354 (10th Cir. 1950).

³⁰⁶ Repossessions, part of the problem dealt with in § 453(d), will be dealt with in a later article dealing with the disposition of installment obligations.

³⁰⁷ *J.P. Jerpe*, 45 B.T.A. 199 (1941). Price reduction does not constitute a disposition of an installment obligation. *Rev. Rul. 55-429*, 1955-2 CUM. BULL. 252. Failure of the seller to collect the full original selling price when his original intention was to do so does not reduce the selling price with regard to the 30% rule. *Vincent P. Vigilante*, 35 P-H Tax Ct. Mem. 957, 958 (1966).

³⁰⁸ The loss, however, is not a capital loss. *Hale v. Helvering*, 85 F.2d 819 (D.C. Cir. 1936).

³⁰⁹ 97 F.2d 891 (5th Cir. 1938).

would similarly be subject to "such provisions of the law as might be of force at their maturity."³¹⁰ In *Snell*, what would have been capital gain entirely had the taxpayer not elected section 453 treatment, was converted into ordinary income as a result of an intervening change in the statute. The rationale of *Snell* is that since the taxpayer "chose to defer . . . installments," the effect of a subsequent change in the law "was a risk [he] took in deferring the realization of his gains."³¹¹

Although the result reached seems firmly ensconced in the fabric of the law,³¹² the decision seems open to question. To the extent that the court refers to section 453 as deferring realization of income, it is in error. The taxpayer realizes gain in the year of sale. Since the gain realized does not fall within one of the several nonrecognition provisions, it must be viewed as recognized gain as well. In *Snell* the gain was realized in the year of sale, and its mode of taxation, as capital gain or ordinary income, should not have been altered because of an intervening change in the statutory framework. Although this appears to be the proper result, the issue is rarely contested, because of the infrequency of legislative changes in the definitional aspects of capital gains taxation.

An assertion by the Commissioner that the subsequent installment payments received by the seller are to be treated as ordinary income rather than capital gain can arise in a context distinct from legislative change. For example, the taxpayer may begin selling parcels of real property in 1961 and 1962 in a manner qualifying for return under section 453. The income returned in those years may be treated by the taxpayer as capital gain as a result of his belief that the realty was not held "primarily for sale to customers in the ordinary course of his trade or business."³¹³ Although the statute of limitations may have expired for the years of sale, the Commissioner is not barred from urging that the subsequent installment receipts generated by the earlier sales should be treated as ordinary income because the sales, in fact, were of property held primarily for sale to customers.³¹⁴ This result should not be surprising. The years to which the later installment receipts have been deferred are open and subject to any adjustments the Commissioner may propose. That the Commissioner is able to support proposed adjustments for later years by going back to the year of sale to determine the true nature of the disposition supports the conclusion

³¹⁰ *Id.* at 893.

³¹¹ *Id.*

³¹² *E.g.*, Zola Klein, 42 T.C. 1000, 1004-05 (1964).

³¹³ INT. REV. CODE of 1954, § 1221(1).

³¹⁴ *Municipal Bond Corp.*, 41 T.C. 20, 31-32 (1963), *rev'd on other grounds*, 341 F.2d 683 (8th Cir. 1965).

that the sale actually takes on its character from the circumstances existing in the year of sale. This further weakens the result in *Snell*.

When a business is sold in a transaction qualifying for return under section 453, allocation of the installment receipts between capital and ordinary income should not create problems. The manner in which the disposition of assets was handled in *Rhombar Co.*³¹⁵ is instructive on this point, as well as with regard to the recommended separate disposition of inventory. In *Rhombar* the taxpayer, a distributor of fine furniture, sold its assets to another corporation by an agreement that grouped the assets in broad classifications. For the goodwill the seller was to receive \$750,000, and for the fixed assets (*e.g.*, decorations, room settings, show room furniture, etc.) the seller was to receive \$150,000, although the properties falling within this latter group were valued at \$210,000. For the assets falling within these two groups the purchaser was to make forty quarter-annual installments of \$22,500 each. The purchaser was unable to make the payments as provided, and in the years under consideration by the court the selling taxpayer received substantially less than the amount agreed. Since five-sixths of the purchase price for this group of assets was allocated to goodwill, the court (and, indeed, the Commissioner) readily found that five-sixths of what the seller actually received during this period could properly be treated as capital gain. The Commissioner urged that the remaining one-sixth of what the taxpayer received was ordinary income, since the assets sold were not shown to constitute inventory. The court, however, noting that the inventory "was sold separately,"³¹⁶ and concluding that the assets in the group referred to constituted section 1231 property,³¹⁷ found that the remaining amount should also be treated as capital gain.

VII

SALES BY DEALERS IN PERSONALTY

Although use of the installment method by dealers in personal property presents many unique problems, most of them involve intricate questions of accounting that are outside the scope of this article. The Commissioner's regulations on use of the installment method by dealers in personalty³¹⁸ constitute a quagmire in which all but the most persistent lawyer would quickly become lost if, indeed, there existed sufficient reason for him to enter it at all. Nonetheless, certain

³¹⁵ 47 T.C. 75 (1966).

³¹⁶ *Id.* at 88.

³¹⁷ *Id.* at 89.

³¹⁸ Treas. Reg. § 1.453-2, T.D. 6682, 1963-2 CUM. BULL. 197, 198, *as amended*, T.D. 6804, 1965-1 CUM. BULL. 215, 217-20.

problems in the application of the installment method in this context are of interest to the lawyer.

A. *Qualifying Sales by Dealers—Generally*

The statute has provided since its inception in 1926 that a "person who regularly sells or otherwise disposes of personal property on the installment plan . . ." may adopt the installment method.³¹⁹ This slender phrase contains questions central to the use of the method. Except for the long-broiling controversy, now apparently settled, about whether revolving credit plans constitute a sale on the installment plan, the regulations are simple and undemanding in their statement of what constitutes a sale of this character.³²⁰ No requirements or limitations exist with respect to the amount of down payment, payments made during the year of sale, sales price, or period over which the payments are to be received. An installment sale "contemplates that each sale under the plan will be paid for in two or more payments," whether or not it is in fact paid for in more than one installment.³²¹

The revolving credit plan lacks this characteristic; it is not contemplated that each sale will be paid for in more than one installment. Not only can the buyer pay the account balance in full at any time under such a plan, but also there is no way to determine whether a particular sale is to be, or is in fact, paid for in installments. The regular payments of the buyer are not specifically attributable to the price

³¹⁹ INT. REV. CODE OF 1954, § 453(a).

³²⁰ Treas. Reg. § 1.453-2(b), T.D. 6682, 1963-2 CUM. BULL. 197, 198.

³²¹ *Id.* Prior to the expansion of the regulations effected by T.D. 6682, 1963-2 CUM. BULL. 197, the regulations contained no definition concerning sales on the "installment plan." Significantly, the determination of whether a sale is made on the installment plan is separate from the determination of eligibility to use the method of reporting income. The regulations make the intention of the parties paramount by indicating that an installment plan sale is one which "contemplates" that the sale will be paid for in two or more installments. Thus, the sale may still qualify as an installment plan transaction as long as the requisite "contemplation" exists, even though the buyer subsequently pays the entire purchase price in one payment. The classification of such a transaction as an installment sale would simply entitle the dealer to report the entire gain from the transaction at the time of its receipt, which will, if in an accounting period subsequent to the year of sale, supply deferral. Its classification as an installment plan transaction could also be significant in determining whether or not the taxpayer is "regularly" engaged in selling on the installment plan. Of course, if the agreement contemplates that the entire sales price is to be paid at once, though subsequent to the year of sale, the transaction is not a sale on the installment plan. Thus, the transaction could not be considered in determining whether the taxpayer "regularly" sells in that manner, nor would it be eligible for the installment method of reporting income.

The regulations, however, seem to require that sales on a revolving credit plan must actually be paid for in two or more installments. Since the buyer can liquidate any portions of the revolving credit balance that he desires, it may frequently be the case that each sale made under the plan is not, in fact, paid for in two or more installments.

of a particular item, but merely reduce the total unpaid balance, which may be the aggregate of several separate purchases. Thus, revolving credit plans do not possess the traditional characteristics of a sale on the installment plan simply because the total obligation of the buyer is paid in installments. Absent administrative concession, the tax effect to the merchant would be determined outside section 453, with the result that a tax would be imposed in the year of sale on the full amount of the gain.³²²

When the Commissioner sought to challenge the eligibility of revolving credit plans under section 453, he relied upon the characteristic absence of a retained security interest in the seller and its usual presence in the more traditional plans.³²³ Since he argued that *none* of the sales made under the revolving credit plan could qualify as installment plan sales, the Commissioner's position in the case was somewhat extreme and cannot properly be considered as part of the rational development of his policy on the matter. Although revolving credit plans were not in use in 1926, and hence not within the area in which Congress sought to provide relief, the court concluded that there was nothing in the statute, in its administrative interpretation, or in the ordinary meaning of "installment plan," that would deny this modern credit device shelter under the statute.³²⁴ The Commis-

³²² Under the accrual method, which is usually used by those not employing the installment method, "income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.446-1(c)(1)(ii) (1957). This will almost invariably be in the year of sale. Any deferral obtained through the use of the accrual method will depend upon the valuation of the purchaser's obligations.

The installment method of reporting does not always result in a clear tax saving to the dealer in personalty. A dealer who consistently sells on the installment plan, and who thereby receives recurring annual payments on prior installment plan sales, may at some future time reach a point at which the income to be reported is about the same as would be reported by the accrual method. But in the early years, prior to this equalization, the method can have the beneficial effect of freeing amounts for business growth. Further, in a business marked by regular expansion, the income generated by the receipt of installments on prior and current installment plan sales will never reach the income level that employment of the accrual method would yield.

³²³ *Consolidated Dry Goods Co. v. United States*, 180 F. Supp. 878 (D. Mass. 1960). In very early regulations the Commissioner adopted a policy of not requiring the retention of a security interest as a feature of a sale on the installment plan. This, along with the fact that the statute imposes no such requirement, rendered his position in *Consolidated Dry Goods* clearly untenable. Recently, however, as a result of amendments effected by T.D. 6682, 1963-2 CUM. BULL. 197, the regulations have adopted a distinction between traditional installment plan transactions and sales made under a revolving credit plan, indicating that the former will usually be marked by the dealer's retention of a security interest.

³²⁴ *Consolidated Dry Goods Co. v. United States*, 180 F. Supp. 878, 882 (D. Mass. 1960).

sioner's chief disagreement with this judicial result was that it would allow the taxpayer to report *all* sales made under revolving credit plans on the installment method.³²⁵

Subsequently, regulations were designed to provide standards for determining which portion of the total amount of revolving credit sales would qualify as sales "on the installment plan."³²⁶ In essence, these regulations provide for determination, from a sample of revolving credit sales, of the percentage of such sales that, under the plan, will be, and are in fact, paid for in more than one installment. The resulting percentage is then applied to the aggregate sales from the revolving accounts to determine the amount of sales made under the installment plan.³²⁷ Because the revolving credit regulations were difficult to apply,

³²⁵ Rev. Rul. 60-293, 1960-2 CUM. BULL. 163.

³²⁶ T.D. 6682, 1963-2 CUM. BULL. 197. Proposed regulations issued a year earlier had been modified significantly as a result of objections from the retail industry. Proposed Treas. Reg. § 1.453-2, 27 Fed. Reg. 9920 (1962). The Commissioner took time in developing his stance, having announced in the original regulations promulgated under § 453 that separate rules dealing with revolving credit sales were under consideration. T.D. 6314, 1958-2 CUM. BULL. 160.

³²⁷ Treas. Reg. § 1.453-2(d), T.D. 6682, 1963-2 CUM. BULL. 197, *as amended*, T.D. 6804, 1965-1 CUM. BULL. 215. The regulations adopt the aggregate monthly sales test, which is designed to determine whether it was contemplated that the sale be paid for in two or more installments, and the actual payment test, designed to discover whether the sale was actually paid for in more than one installment. Pursuant to the former (Treas. Reg. § 1.453-2(d)(3)(i), T.D. 6682, 1963-2 CUM. BULL. 197), the sales made during the billing month are treated as made on the installment plan "[i]f the aggregate of sales charged . . . exceeds the required monthly payment" The latter test (Treas. Reg. § 1.453-2(d)(3)(ii), T.D. 6682, 1963-2 CUM. BULL. 197) regards the sale as made on the installment plan if the "first payment after the billing-month of sale . . . is in an amount which is less than the balance of the account as of the close of the billing-month of sale." If a sale passes muster with respect to each of these standards, it qualifies as being made on the installment plan. The goal is to determine what portion of the year-end revolving credit receivables represent profit that is deferrable under § 453(a). This is accomplished through an analysis of the year-end balances of the sample accounts, gathered pursuant to approved sampling techniques, to determine what portion thereof is composed of qualifying sales. For example, assume the total sample year-end balances—pursuant to a mandatory "first in-first out" principle by which the balance is considered to be comprised of the most recent charges (Treas. Reg. § 1.453-2(d)(6)(v), T.D. 6682, 1963-2 CUM. BULL. 197, *as amended*, T.D. 6804, 1965-1 CUM. BULL. 215)—reveal that 80% of the aggregate balances consist of qualifying sales. This percentage is then applied to the total revolving credit balance of the taxpayer to determine the amount that may be treated as sales made on the installment plan. The concluding step is to apply the appropriate gross profit percentage—determined by reference to total installment plan sales, total credit sales, or all sales of the taxpayer—to the total year-end balance, which is treated as being composed of sales made on the installment plan. This reveals the amount of gross profit that may be deferred to succeeding years.

Consistent with the aim of § 453(a), as it applies to dealers, the regulations require elimination of the portion of the year-end revolving credit balances that is deemed to constitute a "nonpersonal property sale." See Treas. Reg. § 1.453-2(d)(6)(iv), T.D. 6682,

Congress in the Revenue Act of 1964 replaced the complex sampling procedure with a simple definitional provision decreeing that an "installment plan" included a revolving credit plan.³²⁸ This effort to broaden the effect of the statute substantially replaced the Commissioner's revolving credit regulations. But it was short lived and is now only of historical importance. Less than six months later Congress had a change of heart and concluded that it "would have been better to have left the Treasury Department with the opportunity to determine by regulation the extent to which sales under revolving credit type plans are to be treated as sales under installment plans."³²⁹ The repealing legislation restored the primacy of the revolving credit regulations.³³⁰ According to the accompanying report, the repeal was made on the Commissioner's assurance that he would continue his effort to simplify the sampling procedures required by the regulation.³³¹

B. *Qualifying Taxpayer Must Regularly Sell on the Installment Plan*

The statute defines a dealer as one "who regularly sells . . . on the installment plan."³³² Though the word "regularly" is not defined, it probably requires a sales pattern of some frequency over a substantial period of time.³³³ Thus, a single sale of inventory cannot qualify the taxpayer as a dealer entitled to eligibility under section

1963-2 CUM. BULL. 197, citing as examples charges made for services, unless "incidental to and rendered contemporaneously with the sale of personal property" Thus, the regulations seem to distinguish between charges for repair, which would not qualify, and installation charges in connection with a sale, which would qualify. Finance charges, unlike traditional installment plan sales, will not be treated as part of the sales price and must be included in income as charged. Treas. Reg. § 1.453-2(d)(6)(i), T.D. 6682, 1963-2 CUM. BULL., as amended, T.D. 6804, 1965-1 CUM. BULL. 215. See also INT. REV. CODE of 1954, § 453(e), requiring that payments received be applied first against finance and service charges. This substantially diminishes the possibility, which existed under the regulations applicable for years prior to 1964 (Treas. Reg. § 1.453-2(d)(6)(v), T.D. 6682, 1963-2 CUM. BULL. 197, as amended, T.D. 6804, 1965-1 CUM. BULL. 215), that the year-end balances contain a disproportionate amount of nondeferrable finance charges.

³²⁸ Act of Feb. 26, 1964, Pub. L. No. 88-272, § 222, 78 Stat. 75.

³²⁹ S. REP. NO. 1242, 88th Cong., 2d Sess. 5 (1964). But Congress supplied significant legislative history, which clarifies the basic issue of when the method may be used, by stating that "[i]n taking this action, your committee intends that the term 'sales on the installment plan' be interpreted by the regulations as covering 'sales on a revolving credit type plan'" *Id.*

³³⁰ Act of Aug. 31, 1964, Pub. L. No. 88-539, § 3(b), 78 Stat. 746.

³³¹ Rev. Proc. 65-5, 1965-1 CUM. BULL. 720, *modifying* Rev. Proc. 64-4, 1964-1 (Part I) CUM. BULL. 644, promulgates further sampling guidelines.

³³² INT. REV. CODE of 1954, § 453(a)(1).

³³³ The provision contemplates a business that is "to continue for a substantial period of time and to involve numerous transactions." 50 E. 75th St. Corp. v. Commissioner, 78 F.2d 158, 160 (2d Cir. 1935) (A. Hand, J.).

453(a).³³⁴ When the seller is not regularly engaged in making such sales, must eligibility depend upon meeting the election and price floor requirements that relate to casual sales of personalty? Apparently Congress intended to draw the familiar distinction between transactions that take place in a business setting and those that do not. By using antonyms ("regular" and "casual"), Congress denied eligibility to the dealer unless he sells on the installment plan with some frequency. If his installment sale transactions do not rise to that level, he cannot qualify them as casual property dispositions, because property held for sale to customers cannot be the subject matter of a casual transaction.³³⁵ Therefore, if the taxpayer does not sell on the installment plan with the frequency required in section 453(a)(1), qualification can only result from a showing that the sale was not made in the usual course of the taxpayer's business.³³⁶ Although not expressly stated in the statute, the inclusion of the word "dealer" in the caption of section 453(a) seems to indicate that qualification is dependent upon the sale arising from a "business" of the taxpayer, not in the broad sense of profit seeking, but rather in the narrow sense in which the term was construed to have been used in section 162, dealing with business deductions.³³⁷ Thus, in *E.P. Greenwood*,³³⁸ the taxpayer successfully qualified, as casual dispositions of personalty, the installment plan disposition, involving more than 200 separate sales, of a large stock interest in an insurance corporation of which he was president. The court stated:

The actual sale of these shares of stock was accomplished by many transactions, but neither that fact, nor the length of time such transactions consumed, characterizes them as having been made by "a person who regularly sells or otherwise disposes of

³³⁴ This seems clear by the statute and explains why the taxpayer in *G.C.M.* 1162, VI-1, CUM. BULL. 22 (1927), attempted to qualify his lone installment plan sale of inventory property as a casual sale of personalty.

³³⁵ "Casual" modifies "sale" and does not refer to the terms and conditions of the transaction; thus, sales that are a part of the taxpayer's regular course of business seem to be excluded. The language added by the Revenue Act of 1928, ch. 852, § 44(b), 45 Stat. 805 (now INT. REV. CODE of 1954, § 453(b)(1)(B)), denying eligibility to "property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year . . ."—which in effect codified the result of *G.C.M.* 1162, VI-1 CUM. BULL. 22 (1927)—was a clarifying and not a necessary change. Cf. *Ann Edwards Trust*, 20 T.C. 615, 618 (1953), *aff'd*, 217 F.2d 952 (5th Cir.), *cert. denied*, 349 U.S. 905 (1955).

³³⁶ See *50 E. 75th St. Corp. v. Commissioner*, 78 F.2d 158 (2d Cir. 1935), involving a builder's sale of stock in a cooperative apartment corporation.

³³⁷ See *Higgins v. Commissioner*, 312 U.S. 212 (1941), holding that the taxpayer's large investment portfolio did not constitute a trade or business within the predecessor of § 162. This compelled the subsequent enactment of the predecessor to § 212.

³³⁸ 34 B.T.A. 1209 (1936).

personal property on the installment plan" or any other plan. Such transactions were casual sales. A business which is limited to the disposition of certain specific property of an individual is not a business regularly carried on under [the applicable statute]³³⁹

The capital gain cases are very helpful in determining whether the taxpayer is making the sale as a dealer or nondealer. Of course, whether the taxpayer is selling in the capacity of a dealer (*i.e.*, disposing of inventory type property) is a consideration distinct from whether the taxpayer has sold on the installment plan with sufficient frequency to qualify under section 453(a)(1). If the taxpayer fails to establish that sales have occurred with the regularity demanded by that section, he can presumably argue that the sale is casual and not made as a part of the regular course of his business. Of course, this invokes the price floor requirement and the ceiling on year-of-sale payments that relate to casual sales. Also, the stringent election requirements that the Commissioner seeks to apply to casual sales would apply. In such a situation, the personal property cases arising under section 1221(1) would be analogous.³⁴⁰ The Commissioner has failed to take a strong litigation position on the question whether the taxpayer sells property on the installment plan with sufficient frequency to qualify under the statute. Consequently, while a lone sale of inventory property will not qualify, a pattern involving only slightly more would likely pass judicial muster.

Some decisions have not considered the proportion between installment and noninstallment sales as controlling. The statute makes eligible one who "regularly" sells pursuant to this method; no premium is placed on the relative volume of business done on that basis.³⁴¹ Yet, in one case the proportion of installment plan transactions to total transactions was considered in solving the factual question of "regularity."³⁴² The cases have also considered sales frequency (*i.e.*, the number of total sales made on the installment plan) and whether the taxpayer gener-

³³⁹ *Id.* at 1212.

³⁴⁰ See, *e.g.*, Estate of Jacques Ferber, 22 T.C. 261 (1954), concerning whether a large-scale disposition of inventory by decedent dealer's estate (which may involve several separate transactions) is eligible for treatment as a casual sale. On an installment sale of "investment securities" by a dealer in securities, the Commissioner could take the position that the dispositions were casual, thus using the regular-casual dichotomy to seek non-qualification by invoking the year-of-sale ceiling and minimum price requirements.

³⁴¹ Marshall Bros. Lumber Co., 13 B.T.A. 1111, 1116 (1928), *rev'd per curiam*, 51 F.2d 1081 (6th Cir. 1931). Though classed as "incidental," the taxpayer's installment plan sales (6% of total sales) were still of sufficient regularity to warrant qualification. This indicates the minor importance of relative installment plan sales volume. Herman Tillman, 10 B.T.A. 4, 6-7 (1928).

³⁴² Louis Greenspon, 23 T.C. 138, 152 (1954), *modified*, 229 F.2d 947 (8th Cir. 1956).

ally held out to the public a willingness to conduct business on that basis.³⁴³ For example, the court is willing to view installment sales that involve a substantial portion (in dollars) of the total sales volume as a proper substitute for literal frequency in the number of such sales.³⁴⁴

Though a taxpayer regularly sells on the installment plan, it must appear that the proceeds that he seeks to report according to the installment method are received as a result of a "sale." This, of course, is an attribute of the statute applicable to nondealers as well. In most instances this requirement will not create problems. The statutory provisions relating to general principles of gain realization ("sale or other disposition of property")³⁴⁵ and to eligibility for capital gains treatment ("sale or exchange of a capital asset")³⁴⁶ afford a sufficient basis for solving most of the problems concerning the word "sale" in section 453(a)(1). Also, the statute provides eligibility for a taxpayer "who regularly sells or otherwise disposes," of property. Thus, the frame of reference is broadened to include transfers that technically are not "sales." Questions relating to these provisions parallel those that might arise concerning transfers by nondealers, discussion of which is contained elsewhere.³⁴⁷

C. *The Realty-Personalty Distinction*

For dealers in personalty to qualify under the statute, they must be regularly engaged in the sale or disposition of "*personal property*."³⁴⁸ The Commissioner commences consideration of the realty-personalty dichotomy by asserting that the statutory language should be given its ordinary effect, and thus a sale or disposition of real property "must mean a sale or other disposition of land or of rights in or to land."³⁴⁹

Administrative pronouncements aimed at the solution of specific

³⁴³ Davenport Machine & Foundry Co., 18 T.C. 39, 43 (1952); Marshall Bros. Lumber Co., 13 B.T.A. 1111, 1116 (1928), *rev'd per curiam*, 51 F.2d 1081 (6th Cir. 1931).

³⁴⁴ Louis Greenspon, 23 T.C. 138 (1954), *modified*, 229 F.2d 947 (8th Cir. 1956). In that case there were only 4 sales, involving 2 customers, but these sales comprised 22% of total sales made by taxpayers during the year. Further, the size of the markup and purchase price may be relevant. Thus, a dealer in hard goods may be allowed to qualify with fewer sales.

³⁴⁵ INT. REV. CODE OF 1954, § 1001(a).

³⁴⁶ INT. REV. CODE OF 1954, § 1222.

³⁴⁷ See pp. 198-202 *supra*.

³⁴⁸ INT. REV. CODE OF 1954, § 453(a)(1) (emphasis added). If the taxpayer fails to qualify the property as personalty, he might be able to report the proceeds—assuming he properly elects to do so in a context in which each sale is an elective event—as gain from the sale of realty, but only at the expense of becoming subject to the 30% ceiling on year-of-sale payments.

³⁴⁹ G.C.M. 7871, IX-1 CUM. BULL. 207, 209 (1930).

problems in this area have, however, been unwisely abstract. Most difficulties have arisen with respect to taxpayers engaged in home construction. This business raises questions not only concerning the realty-personalty distinction, but also whether the taxpayer is involved in the disposition of property at all, or is simply engaged in rendering a service. Again, the Commissioner is probably on firm ground when he states that, in the interest of uniform application of the revenue system, local law nuances should not be considered in solving problems touching on the nature of the property transferred.³⁵⁰ The Commissioner properly determined that the disposition of roofs already constructed and of roofing materials and their attachment to buildings is not the disposition of realty within the predecessor of section 453, the inference being that the property involved was personalty.³⁵¹ Although the Commissioner alluded to the material-labor differential (80% and 20%, respectively) involved in the construction and installation of the roofs, it was in a later ruling that he concluded, albeit tentatively, that the construction of houses can constitute the rendering of a service rather than the disposition of property.³⁵² While ruling that the sale of factory-built houses by the taxpayer for installation on the purchaser's realty and on foundations not erected by the taxpayer constituted the sale of personalty, the Commissioner also held that the construction of "shell" or partially completed homes on land owned by others did not involve the sale of property but simply constituted the rendition of a service not entitling the taxpayer to eligibility under section 453.³⁵³

This ruling is particularly abstract, since it seems to treat as crucial the place of the construction activity engaged in by the taxpayer. Obviously, expenditure of a labor effort is involved in the manufacture and creation of the finished facility. In the instance ruled on favorably by the Commissioner, the labor was performed in the taxpayer's factory; in the instance held not a sale, the construction took place upon the property of another. The Commissioner has seized this seemingly irrelevant distinction as the basis on which to promulgate a concept of "nonsale" which denies eligibility under section 453. This administrative position was hardened in 1959, when the Commissioner ruled that a taxpayer constructing custom-built houses on land belonging to others is a "building construction contractor" and not a dealer in personalty nor involved in making sales of real property or casual sales of per-

³⁵⁰ Rev. Rul. 59-250, 1959-2 CUM. BULL. 134.

³⁵¹ G.C.M. 7871, IX-1 CUM. BULL. 207, 209 (1930).

³⁵² G.C.M. 27169, 1952-2 CUM. BULL. 120.

³⁵³ *Id.* at 121-22.

sonalty.³⁵⁴ Although the taxpayer may properly have been classified as a building construction contractor, it is difficult to see how this description of his endeavor denies him the right to treat his transactions as property dispositions for the purpose of section 453.

Admittedly, labor as well as material is involved in the home construction process. But this is a hallmark of the manufacturing process generally. There is nothing in the language of section 453, or in the background compelling its enactment, that even vaguely hints either at noneligibility for those engaged in the manufacturing process or at the importance of the labor-material differential in the composition of the manufactured item. Although it failed to cite the 1959 ruling, a subsequent decision of the Tax Court seems in direct contrast. In *W. W. Pope*,³⁵⁵ the taxpayer was permitted to treat the proceeds from the disposition of homes constructed on the property of others as received from the sale of personalty. In sounding a note of reason, the court concluded that the taxpayer "is no more engaged in the sale of services than any other dealer in personal property who is *also* the fabricator of such property."³⁵⁶ Also, the court wisely dismissed the relevance of the locus of the construction activity, finding that the manufacture of the product on the customer's property "was dictated solely by the nature of the product"³⁵⁷ Arguably, though, this decision does not conflict with the 1959 ruling; the court in *Pope* noted that the homes sold by the taxpayer were selected by the purchaser from a standard group of model homes, whereas the 1959 ruling contemplated a situation in which homes were "custom-built" in accordance with agreed specifications.

The Commissioner's position appears to be that at some point the contractor is involved in nothing more than using the real property owner's money to buy material and construct a house according to the owner's wishes. This may be the seed of a valid distinction, although it is difficult to see why the purchaser's selection of the ultimate design converts the transaction into one involving the rendering of services rather than the disposition of property. Presumably, almost every endeavor, including a lawyer's preparation of legal documents, results in property-creation of some character. The difficulty lies in determining whether the activity is primarily service-oriented. Except for the applicability of the ceiling on year-of-sale payments, the realty-

354 Rev. Rul. 59-250, 1959-2 CUM. BULL. 134, 135-36.

355 34 P-H Tax Ct. Mem. 1198 (1965).

356 *Id.* at 1200 (emphasis in original).

357 *Id.*

personalty distinction usually does not determine the taxpayer's eligibility under section 453. Presumably, a timely election to report sales of personalty under section 453(a)(1) would also constitute a timely election under section 453(b), in the event the property sold is later determined to constitute realty.³⁵⁸ The Commissioner's property-services distinction has a far more deadly thrust, for if a transaction is determined to be the rendering of a service, it may not be classified under either section of the installment sales provision of the code. While the basis upon which the Commissioner makes the distinction is not sound, other nooks in the federal tax law may offer a solution to the dilemma.³⁵⁹

D. *Adoption of the Installment Method by Dealers*

Most of the controversy concerning whether the taxpayer has made a timely election of the installment method has arisen with respect to transactions involving sales of realty and casual sales of personalty. In such a context, each sale constitutes a basis for election; this creates a setting in which mishap is likely to occur. Further, the transactions in which nondealers—or even dealers, in the case of real property—become involved are more varied in form. Their true nature, for purposes of the income tax, may be uncertain at the time of filing, whereas the retail transaction in which the dealer in personalty is involved is far more likely to be routine. The elective process by the dealer is much less likely to be a potential trap. The decision to employ the installment method, however, can take two forms. Adoption of the method by a dealer for the first taxable year in which he makes sales on the installment plan is not complex. Greater difficulty is likely to result when a dealer changes to the installment method from another method of tax accounting.

The regulations provide that the decision to adopt the method for the first year of installment sales must be indicated on the "income tax return for that taxable year."³⁶⁰ The regulations further admonish that the decision must be made on a return "filed on or before the

³⁵⁸ The timeliness of the election should not be affected by the taxpayer's failure to properly classify the transaction, since income computation is not thereby affected. Treas. Reg. § 1.453-8(a), T.D. 6682, 1963-2 CUM. BULL. 197; Treas. Reg. § 1.453-8(b) (1958).

³⁵⁹ The revolving credit plan regulations provide that, when the "services are incidental to and rendered contemporaneously with the sale of personal property . . . such charges [for the services] shall be considered as constituting part of the selling price . . ." Thus, the regulations recognize that an amalgam of services and property can be treated entirely as a sale of personal property. Treas. Reg. § 1.453-2(d)(6)(iv), T.D. 6682, 1963-2 CUM. BULL. 197.

³⁶⁰ Treas. Reg. § 1.453-8(a)(2), T.D. 6682, 1963-2 CUM. BULL. 197.

time specified (including extensions thereof) for filing such return.”³⁶¹ Thus, the Commissioner requires for an election by dealers what he does not require of those selling realty or involved in a casual sale of personalty, namely a decision upon a timely return.³⁶² This, of course, was a central issue in the controversy that raged concerning dispositions of realty and casual sales of personalty. The taxpayer-dealer who files a return on which he reports the income from installment sales pursuant to an accounting method other than the installment method should not be permitted to adopt the installment method via either an amended return for that year or a claim for refund.³⁶³ Since, in most situations, the taxpayer-dealer will have reported the income received from installment sales according to one method or another, he will be pinned with a binding election, and the question whether the taxpayer made any election at all should not be present. Nevertheless, some questions concerning the timeliness of an election in the case of a sale of realty or a casual sale of personalty can also apply in situations involving dealers of personalty. For example, where no inconsistent election has been made, the Commissioner apparently will not accept an election made on a late return or on an amended return filed before the expiration of the statute of limitations.³⁶⁴

Although the statute transfers to the Secretary or his delegate the power to promulgate legislative regulations concerning use of the installment method by dealers, it is still relevant to ask whether the requirement of the regulation may be considered “unauthorized as adding limitations beyond that authorized in the statute itself.”³⁶⁵ This is not an easy road to pursue, however, especially in an area where Congress has delegated broad authority to the administrator of the statute. Nevertheless, no reason appears why the Commissioner’s policy about the timeliness of an election to use the installment method should not be identical with respect to all types of sales potentially eligible under the statute. Thus, he should permit dealers in personalty to adopt the installment method on delinquent returns or on an amended return for an

³⁶¹ Treas. Reg. § 1.453-8(a)(1), T.D. 6682, 1963-2 CUM. BULL. 197.

³⁶² Rev. Rul. 65-297, 1965-2 CUM. BULL. 152; *see* detailed discussion of election at pp. 215-31 *supra*.

³⁶³ *Pacific Nat'l Co. v. Welch*, 304 U.S. 191 (1938); *Kay-Jones Furniture Co.*, 24 P-H Tax Ct. Mem. 789 (1955). Conversely, the choice of the installment method is also binding, and the taxpayer may not file an amended return using a different accounting method.

³⁶⁴ Treas. Reg. § 1.453-8(a)(1), T.D. 6682, 1963-2 CUM. BULL. 197; *cf.* Rev. Rul. 65-297, 1965-2 CUM. BULL. 152.

³⁶⁵ *C'de Baca v. Commissioner*, 326 F.2d 189, 190 n.2 (5th Cir. 1964).

open year, if an inconsistent election has not been made. Of course, this situation is not likely to arise.

E. Change from the Accrual to the Installment Method

Similarly, a change to the installment method from another method used by the taxpayer-dealer to report income from installment plan sales must be made on a statement filed with a timely return.³⁶⁶ The difficulty has been not in effecting the change³⁶⁷ but rather in determining whether installment receipts received after the change to the installment method, but related to sales occurring prior to the change, shall be included in computing the gross profit reported as installment income. Prior to the 1954 Code, subsequent installment receipts were included in income when the taxpayer changed from the accrual to the installment method.³⁶⁸ Somewhat oddly, the Congressional concern motivating the 1928 enactment,³⁶⁹ which codified the double-tax administrative position,³⁷⁰ was limited to the "seriously subnormal amount of income" resulting when taxpayers changed from the accrual to the installment method. Since the cash method, through the doctrine of cash equivalence, compels inclusion in income of an amount equal to the fair market value of the buyer's obligation, the change from the cash to the installment method causes a similar drop in income in the years following the change. The administrative action and Congressional response, however, have been limited to changes from the accrual to the installment method.³⁷¹

In 1954 Congress stated that it desired to eliminate the double tax effect occurring in changes from the accrual to the installment method. This desire, however, did not manifest itself in any tampering with section 44(c) of the 1939 Code, which was recodified as section 453(c)(1) of the 1954 Code. Rather, Congress used the familiar tactic of adding a tax credit for the year in which the installment plan receipt is included in

³⁶⁶ Treas. Reg. § 1.453-8(a)(1), T.D. 6682, 1963-2 CUM. BULL. 197.

³⁶⁷ Contrary to the principle normally applicable to changes in accounting method, consent is not required to change to the installment method. Treas. Reg. § 1.453-7(a), T.D. 6682, 1963-2 CUM. BULL. 197. See also INT. REV. CODE of 1954, § 446(e).

³⁶⁸ INT. REV. CODE of 1939, ch. 1, § 44(c), 53 Stat. 25.

³⁶⁹ Revenue Act of 1928, ch. 852, § 44(c), 45 Stat. 805.

³⁷⁰ See pp. 189-90 *supra*. The uncertainty of the Commissioner's administrative position on this question prior to the Congressional enactment of 1928 is fully chronicled in *Hoover-Bond Co. v. Denman*, 59 F.2d 909 (6th Cir. 1932), and *Willcuts v. Gradwohl*, 58 F.2d 587 (8th Cir. 1932).

³⁷¹ Infrequently, a question may arise concerning whether the taxpayer effected a change in accounting at all. *E.g.*, *J.C. Nichols Land Co. v. Commissioner*, 65 F.2d 437 (8th Cir. 1933); *S. Davidson & Bros.*, 21 B.T.A. 638 (1930).

income for the second time.³⁷² The adjustment allowed is equal either to (a) the tax which is attributable to installment plan sales made prior to the change and which are subject to forced inclusion by reason of section 453(c)(1), or (b) the tax attributable to the installment receipts includible in income by section 453(c)(1) in the adjustment year on account of sales made prior to the change, whichever is less.³⁷³ Although the Congressional intent was to eliminate the double tax caused by the subsequent forced inclusion of installment receipts on pre-change sales,³⁷⁴ the formula does not, as is often the case with such creations, operate in such a utopian fashion. The "whichever is lesser" aspect of the formula fails to insulate the taxpayer against a rising tax rate structure. Thus, for example, the tax for the adjustment year will be reduced only by the tax attributable to the inclusion of such amount in the prior year, when the rates were lower.³⁷⁵

The continuing presence of the double tax potential prompts efforts to avoid its impact. Thus, the stratagem relied on in *City Stores Co. v. Smith*,³⁷⁶ though the case arose under the 1939 Code, is still applicable. In that case the taxpayer sold its installment obligations to a bank, and the Commissioner sought to include, in taxable years subsequent to the change to the installment method, amounts collected by the taxpayer on the installment obligations. In finding against the Commissioner, the court held that the taxpayer had not "actually received"³⁷⁷ any amounts on the installment obligations in the post-change years un-

³⁷² Analogous provisions are found in INT. REV. CODE of 1954, §§ 691(c), 2012, and 2013. Though cast as a deduction and not as a credit, § 691(c) affords relief to the recipient of income upon the death of an individual in instances in which the property right causing such subsequent income generated a prior estate tax liability. Sections 2012 and 2013 provide for credits against the estate tax where there has been a prior tax on essentially the same item.

³⁷³ INT. REV. CODE of 1954, § 453(c)(2); Treas. Reg. § 1.453-7(b), T.D. 6682, 1963-2 CUM. BULL. 197. For example, suppose the taxpayer in the year prior to change had reported on the accrual method gross profit of \$50,000 on installment plan sales. The subsequent receipt of \$10,000 gross profit from such sales in the year of change, although includible in income under § 453(c)(1), would entitle the taxpayer to a credit or "adjustment," equal to the lesser of (1) the portion of the tax for the prior year attributable to the \$10,000 gross profit included in gross income in such prior year, or (2) the portion of the tax attributable to the inclusion of the \$10,000 gross profit amount in gross income (by reason of § 453(c)(1)) in the year of its receipt.

³⁷⁴ S. REP. NO. 1622, 83d Cong., 2d Sess. 65, 303-04 (1954).

³⁷⁵ Also, a change in the tax bracket of the taxpayer in the year he receives the installment may result in failure of the adjustment to compensate completely for the prior inclusion. Even absent this factor, the adjustment may not be fully compensating if the expenses relating to the sale have been claimed in the prior year.

³⁷⁶ 154 F. Supp. 348 (E.D. Pa. 1957).

³⁷⁷ See INT. REV. CODE of 1954, § 453(c)(1)(A).

der review by the court, thus rendering the statute inapplicable. The amounts received by the taxpayer in years subsequent to the change were viewed simply as payments attributable to the previous, bona fide disposition and received on behalf of the buying bank. Although the Commissioner has stated that he will follow *City Stores*,³⁷⁸ the case cannot be viewed as a universal remedy to the problem of the partial second tax. The *City Stores* court found, and the Commissioner's ruling requires, that the disposition of the installment obligations constitutes a sale in substance and not simply a loan or advance. It may not be possible for the taxpayer to effect a sale of receivables. The "buyer" may insist on some degree of continuing involvement and obligation on the part of the "seller" that will cause the transaction to fall short of "sale" classification. Even effecting an agreement may be difficult, either because of the buyer's dissatisfaction with receivables as an item upon which its "credit" should be extended or because of the seller's unwillingness to countenance the discount demanded.³⁷⁹

It might be asked whether a corporation formed in a tax-free organization transfer, or a partnership formed through similar tax-free transfers, by previously unrelated individuals must, in adopting the installment method upon formation, be subject to the second tax bite imposed by section 453(c)(1) with respect to installment plan sales reported on the accrual method in pre-formation years. The Commissioner has ruled that the second tax principle does not apply when receivables are acquired by a corporation in a tax-free organization transfer. He reasons that the newly created corporation is a new taxpaying entity, and thus there is no "change" in accounting method by the corporation.³⁸⁰ Although the Commissioner reaches the same conclusion for newly created partnerships,³⁸¹ the same reasoning does not apply, since the tax law does not treat a partnership as a tax-paying entity. Nonetheless, among the elections made by the partnership as an entity are those affecting the computation of income.³⁸² Thus, the Commissioner's ruling is sound. These principles should continue to apply in all situations in which installment plan receivables previously reported on the accrual method are transferred to a new entity which chooses to adopt the installment

378 Rev. Rul. 59-343, 1959-2 CUM. BULL. 136-37.

379 See Tovey, *How To Sell Receivables and Switch to Installment Accounting Without Double Tax*, 16 J. TAXATION 354, 355 (1962). See also Wiese, *Techniques of Installment Sales and Revolving Credit: Methods of Election; Bulk Sales of Receivables and Notes*, N.Y.U. 23D INST. ON FED. TAX. 905, 908-09 (1965).

380 I.T. 2521, IX-1 CUM. BULL. 123 (1930).

381 I.T. 3293, 1939-1 (Part 1) CUM. BULL. 183.

382 INT. REV. CODE OF 1954, § 703(b).

method. For example, a trust or estate receiving such property should be able to adopt the installment method without potential second tax impact on receipt of payments for prior installment plan sales reported on the accrual method. This result seems less clear, however, if the trust income is taxed to the grantor under the Clifford provisions of the Code.³⁸³ In that situation, it is difficult to conclude that a separate tax-paying entity is created, since the income is treated as owned by the grantor.³⁸⁴ Adoption of the installment method by the Clifford trust may be treated as a "change" in method by the grantor, which would subject him to a second tax.

The acquiring corporation in a Type A or Type C reorganization probably cannot adopt the installment method for acquired receivables without fear of a second tax impact on sales reported on the accrual method by the transferring corporation. Although this is not codified in the statutory material dealing with the carryover of corporate attributes,³⁸⁵ the "continuity of business enterprise" doctrine, which permeates the reorganization area, seems to distinguish this type of situation from a transfer of installment receivables to a newly formed corporation by an individual. Thus, adoption of the installment method by the acquiring corporation would be a "change" within section 453(c)(1). The opposite view, of course, stresses the entity aspect, urging that the acquiring corporation is not the same taxpayer as the one that previously reported income on the accrual basis.³⁸⁶

An organization's change from a tax exempt status to a taxable status would not compel the same results with respect to unrealized installment receivables. The treatment to be accorded payments received on previous installment plan sales depends upon which accounting method the organization selects. If it adopts the accrual method, the subsequent receipts should have no tax effect, since the items did not accrue during the taxable year. Adoption of the installment method, however, will compel inclusion in the later years of receipt of the unrealized income as "installment payments actually received" under section 453(a)(1).³⁸⁷ In this context, therefore, a "change" to the installment method, if it can be viewed as such, would probably be unwise. Further, the adjustment

383 INT. REV. CODE of 1954, §§ 671-78.

384 INT. REV. CODE of 1954, § 671.

385 INT. REV. CODE of 1954, § 381(c)(8), provides for the carryover of the installment method to the acquiring corporation, but is not applicable here.

386 See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 602-10 (2d ed. 1966).

387 Rev. Rul. 55-437, 1955-2 CUM. BULL. 548. Adoption of the cash method by the newly taxable entity would also compel the inclusion in income of the subsequently received installment payments.

in tax for years after adoption of the installment method would not be applicable, since no amounts attributable to such sales were included in income in the pre-adoption years.

The potential second tax bite of section 453(c)(1) brings up, in another context, the problem of defining an installment sale. The statute provides that the second inclusion shall result when the taxpayer receives "installment payments . . . on account of sales or other dispositions of property made . . . before the year of change" ³⁸⁸ Failure of the statute and regulations to provide an adequate definition of an installment sale produced a curious result in *Louis Greenspon*. ³⁸⁹ After finding that the taxpayer was regularly engaged in selling on the installment plan during 1949, the court addressed itself to the receipt in that year of amounts in satisfaction of a sales contract entered into in 1948. The court properly concluded that section 453(c)(1) would not apply if the 1948 transaction could not be regarded as a sale on the installment plan. ³⁹⁰ Although the sale in question was originally finalized on a cash basis, the agreement was subsequently modified, with payment to be made in five equal installments, the last four of which were paid in 1949.

In deciding for the taxpayer—i.e., that section 453(c)(1) did not apply because the prior sale was not made on the installment plan—the court stated that it could not countenance a contrary result, which would cause every sale made on the credit of the purchaser and evidenced by obligations payable periodically to be classified as an installment plan sale. And yet, what more is an installment sale? The current regulations ask for no other qualities. ³⁹¹

By relying on the assertion that the taxpayer was not regularly selling on the installment plan in 1948, the court mistakenly considered eligibility to use the installment method of reporting as a hallmark of an installment sale. Whether the taxpayer was eligible to adopt the installment method with respect to the 1948 sale is a consideration entirely independent of whether the sale itself was on the installment plan. Thus, the court should have treated the 1949 receipts generated by the 1948 sale as subject to the machinery of section 453(c)(1).

F. Operation of the Statute as It Relates to Dealers

Although the manner in which the installment income of dealers in personalty is computed is the same as with the installment method gen-

³⁸⁸ INT. REV. CODE OF 1954, § 453(c)(1)(A).

³⁸⁹ 23 T.C. 138, 152-55 (1954), modified, 229 F.2d 947 (8th Cir. 1956).

³⁹⁰ Rev. Rul. 54-111, 1954-1 CUM. BULL. 76, 77, remedies a minor ambiguity in the statute by indicating that § 453(c)(1) refers "only to amounts received on account of installment sales made in prior years"

³⁹¹ Treas. Reg. § 1.453-2(b), T.D. 6682, 1963-2 CUM. BULL. 197.

erally, certain problems apply particularly to the dealer. Here, as with installment method reporting generally, the taxpayer reports as income that proportion of the total amounts received on the installment plan which the gross profit realized or to be realized on the total sales on the installment plan during the year bears to the total contract price of all such installment sales. The amount treated as income is thus determined by a fraction, the numerator of which is the gross profit on total installment plan sales and the denominator of which is the total contract price of all such sales.³⁹² Defining the components of the relevant fraction, however, presents some problems.

Gross profit should be determined according to generally accepted principles. Though "cost of goods sold" is utilized in determining gross profit, there remains the question concerning what further items may be considered in making the determination. Early in the history of the statute, it was ruled that a taxpayer regularly selling on the installment plan

may not allocate the expenses incident to producing the income to the year in which the profits on the sale of goods are realized, but should deduct such expenses in his income-tax return as for the year in which incurred and paid or accrued.³⁹³

The deferral of expense items to subsequent years could reduce gross profits and the amount of installment income for that year. Such items as administrative expenses, therefore, must be deducted in the year in which paid or accrued (depending on the taxpayer's accounting method) and cannot be deferred to later years in which installment income incident to such expenses is generated.

The denominator of the fraction to be applied to installment plan sales receipts, *i.e.*, total contract price, was recently given statutory embellishment. Although the statute's use of "total contract price" apparently refers to the total amount to be paid by the buyer, the regulations also refer, in the same context, to total selling price.³⁹⁴ To assure the dealer's right to defer income received in the form of interest or carrying charges, Congress amended the statute in 1964 to provide for inclusion of such amounts in the total contract price.³⁹⁵ The Commissioner had ruled earlier that carrying charges or so-called time-price differen-

³⁹² Concerning the allocation of installment sale receipts subsequent to the year of sale, see *Treas. Reg. § 1.453-2(c)*, T.D. 6682, 1963-2 CUM. BULL. 197, *as amended*, T.D. 6804, 1965-1 CUM. BULL. 215.

³⁹³ O.D. 844, 4 CUM. BULL. 123 (1921). *See also* *Blum's, Inc.*, 7 B.T.A. 737 (1927); *Treas. Reg. § 1.453-1(b)*, T.D. 6873, 1966-1 CUM. BULL. 101.

³⁹⁴ *Treas. Reg. § 1.453-2(c)(2)*, T.D. 6682, 1963-2 CUM. BULL. 197, *as amended*, T.D. 6804, 1965-1 CUM. BULL. 215.

³⁹⁵ INT. REV. CODE of 1954, § 453(a)(2), *added by* Act of Aug. 31, 1964, Pub. L. No. 88-539, § 3a, 78 Stat. 746.

tials determined at the time of each sale and added to the established selling price were part of the "total contract price" and hence deferrable over the period of the contract.³⁹⁶ Pursuant to unpublished policy, however, the Commissioner attempted to distinguish between an amount paid as a result of a flat charge added to the price at the time of the contract and an amount yielded as a result of the imposition of a charge on the monthly unpaid balance of the buyer, the latter being denied inclusion in the total contract price. Concluding that any distinction premised on the manner in which the customer is billed for the carrying charge is "superficial," Congress provided that any carrying charge or interest that is added to the selling price on the books of account of the seller may be included in the "total contract price."³⁹⁷ The legislative change, therefore, allows any form of time-price differential to be reported ratably as the installment payments are received rather than on an accrual basis as the carrying charge, or interest, is earned.

VIII

CONCLUSION

The rules surrounding the accounting of income for tax purposes rely heavily, as indeed they should, on the taxpayer's own method of accounting. The installment method of reporting income, however, cuts across traditional accounting approaches. Although the statutory method of deferral is available only for income generated by property dispositions, such dispositions represent a significant portion of the myriad revenue-producing activities in which taxpayers engage. Also, since property dispositions are the only income-producing activity in which taxpayers regularly receive payment in the form of evidences of indebtedness and thus may be unable to pay the tax generated, no great need appears for extending income deferral to other areas, except possibly with respect to prepaid income.

The manner in which section 453 is cast, together with the Commissioner's rigid litigation position concerning various aspects of the section's effect, has created difficulties for taxpayers seeking qualification. Although the seemingly familiar language has been part of the statute for more than forty years, its ambiguities are not yet completely resolved. If nothing else, this indicates that ease of interpretation and administration do not necessarily flow from longevity. If we expect greater simplicity in reporting installment income, we must recognize the need for affirmative statutory modification.

³⁹⁶ Rev. Rul. 64-126, 1964-1 (Part 1) CUM. BULL. 170, *modified*, Rev. Rul. 67-316, 1967 INT. REV. BULL. No. 39, at 7.

³⁹⁷ S. REP. NO. 1242, 88th Cong., 2d Sess. 3 (1964).